THE ROLE OF MONETARY AND FINANCIAL REFORM IN APPROACHING THE EUROPEAN UNION

- THE CASE OF SERBIA -

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Abstract

By making use of various social science research methods, in particular semi-structured interviews, this thesis reveals the main features of the Serbia's 15-year long transition experience, which took place against a background of frequent constitutional changes over the period 1989 to 2004. Serbia's transition began in December 1989 with the *Marković* programme, while the Republic was a constitutive part of the Socialist Federal Republic of Yugoslavia (SFRY). The study confirms that the SRFY was the first country to start transition from a socialist to a market economy, but that this advanced position was lost due to a lack of political consensus, and the dissolution of the country in 1991.

As part of the Federal Republic of Yugoslavia (FRY) which was formed in 1992, Serbia during the 1990s went through the most devastating period in its modern (economic) history, experiencing the second highest and the second longest hyperinflation ever registered (1992-1994). The battle against (hyper)inflation and economic recovery took the form of the *Avramović* programme of January 1994, but failed to deliver any prolonged stabilisation and growth. Additionally, during the period of FRY, when *Slobodan Milošević* was in power, an extensive regime of economic and non-economic sanctions were imposed on Serbia by the international community (1991-2000). Moreover, in 1999, the country was faced with the seriousness of the Kosovo conflict and NATO bombing, and the concomitant impact of these events on economic life. As a result of all this, Serbia's transition process was stillborn throughout much of the 1990s and public confidence in the state institutions, including the National Bank of Serbia (NBS), was entirely lost.

Transition resumed in 2001, following the 'bulldozer revolution' of 5 October 2000, and has since followed the main postulates of the transition blueprint which was based on the so-called "Washington Consensus". The exchange-rate based stabilisation programme brought positive results as early as 2002 and 2003, notably in bringing down inflation. The combination of a *de facto* fixed exchange rate regime (formally announced as a managed float) and gloomy prospects of an ever-raising current account deficit and public debt, however, gave rise to a wide-ranging debate on the role of exchange rate and monetary policy in the overall process of economic recovery. Our analysis reveals that there is space, although limited due to the high "euroisation" of the Serbian economy, for a more active monetary policy. This would allow a substantial depreciation of the real dinar exchange rate, of importance given the demands of WTO and EU membership, namely full capital account liberalisation.

Since February 2003, Serbia again changed its constitutional robe by becoming a member state of the State Union of Serbia and Montenegro. Following this constitutional change in June 2003, after a decade-long delay, Serbia's central bank reform was eventually initiated and the new NBS Law was enacted. The evidence contained in this work suggests that the NBS's *legal* independence perfectly matches the transitional average, but that the *actual* NBS's independence is a cause for concern. So as to prevent the inclusion of the 'systemic error' into the new Serbian constitution – by which a single person (i.e. the governor) is the sole source of monetary policymaking – the study proposes several principles which may guide the drafting process. Additionally, the thesis points to provisions of the current NBS Law which need to be adapted in line with the EMU *acquis*. The study concludes by rising the question of how the NBS's credibility can be restored, proposing a new NBS's approach to transparency as a possible solution.

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Abbreviations

BIS	Bank for International Settlements
BOALs	Basic Organisations of Associated Labour
CARDS	Community Assistance for Reconstruction, Development and Stabilisation
CBA	Currency Board Arrangement
CDS	Serbian Currency Dinar
CEI	Central European Initiative
CoE	Council of Europe
CPI	Consumer Price Index
CSD	Dinar currency
CTF	Consultative Task Force
DEM	Deutsche Mark
EAR	European Agency for Reconstruction
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECB	European Central Bank; it has legal personality
ECHO	European Community Humanitarian Office
ECU	European Currency Unit
EIB	European Investment Bank
EMS	European Monetary System
EMU	Economic and Monetary Union
EPD	Enhanced Permanent Dialogue
ERM	Exchange Rate Mechanism
ESCB	European System of Central Banks, which includes the ECB and the central banks of all EU member countries; ESCB does not have a legal personality (see also Eurosystem)
EU	European Union
EUR	Euro currency

Eurosystem	Comprises of the ECB and the national central banks of those countries that adopted the euro; Eurosystem is not a synonym for the ESCB
FEC	Federal Executive Council of the SFRY
FRY	Federal Republic of Yugoslavia
GDP	Gross Domestic Product
ICTY	International Crime Tribunal for Yugoslavia
IFIs	International Financial Institutions
ILO	International Labour Organisation
IMF	International Monetary Fund
LTSP	Long-Term Stabilisation Programme
MFA	Macro Financial Assistance
MMER	Monetary Model of Exchange Rate Determination
NATO	North Atlantic Treaty Organisation
NDA	Net domestic assets
NFA	Net foreign assets
OCAs	Optimum Currency Areas
OECD	Organisation for Economic Co-operation and Development
OSCE	Organisation for Security and Co-operation in Europe
PfP	Partnership for Peace
PMR	Programme of Monetary Reconstruction and Economic Revival of Yugoslavia
RM	Republic of Montenegro
RS	Republic of Serbia
SAA	Stabilisation and Association Agreement
SAP	Stabilisation and Association Process
SCG	*Državna zajednica Srbija i Crna Gora* [State Union Serbia and Montenegro]
SDK	*Služba društvenog knjigovodstva* [Social Accounting Service]
SDR	Special Drawing Rights
SFRY	Socialist Federal Republic of Yugoslavia
SPSEE	Stability Pact for South East Europe
UN	United Nations
US	United State of America

USD	US Dollar
WB	World Bank
WTO	World Trade Organisation
YUD	Yugoslav Dinar
ZOP	*Zavod za obračun i plaćanja* [Accountancy and Payment Bureau]

Chapter I Introduction

1.1. Scope of the Study: Western Balkans and Monetary Stability

On 1 May 2004, the European Union (EU) experienced the biggest enlargement by opening its doors to ten new member countries: the Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. Apart form Malta and Cyprus, the rest of these countries were ex-socialist and, in terms of their economic results, ex-transitional countries. This work is inspired by these countries' 15-year long journey towards what they perceived to be a better life, as well as the rich experience they gained along that way. Summarising by words the deeds these countries vividly experienced contributes only modestly to the learning of the world. However, it may be of significance to those still marching along that path, that is, to the Western Balkan countries.[1]

The Western Balkans is the only European region considerably lacking behind the rest of Europe in both, socio-political and economic terms. Traditionally, it has been perceived as a violent and primitive region according to those that specialise in formulating the patterns of historical evolution, the normative historians (see Mazower, 2000). It is even often said that the peoples of the Balkans suffer from a surfeit of history. *History*, as a critical and controllable science, however, is repeatedly in the Balkans confused with the *past* that is "designed to control individuals, or motivates societies, or inspire classes" (Plumb, 1969)[2]. Serbia makes no exception. Economically speaking, though, Serbia has gone through the most turbulent transitional experience of all and is, for this reason, taken as a case study. Serbia at the end of 2004 lagged most behind the prominent reformer countries and its regional partners, even though the country was at the forefront of the transition process back in 1989.

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[1] Western Balkan as a region placed in the southeastern part of European continent composes of five countries: Albania, Bosnia and Herzegovina, Croatia, Macedonia and Serbia and Montenegro.
[2] Quoted by Pavlowitch (2002, p. viii).

Besides, Serbia during the last 15 years has been exposed to some severe exogenous and endogenous (non-)economic shocks, which have significantly slowed down the process of its democratisation and economic recovery. This study attempts to analyse the economic shocks more carefully. Its main intention is to build on the transitional experience of ex-transitional countries and to explore the applicability of solutions employed in those countries in the Western Balkan and Serbia in particular. In order to achieve the proclaimed aims, the study places its investigation within the context of the central-planning legacy of ex-socialist countries of Europe. Bearing in mind, though, that Serbia had never exhibited the features of a *classical* socialist economy as described by McKinnon (1991), this work additionally explores the applicability of the general transition monetary policy rules in Serbia during the period 1989-2005.

A modest contribution of this thesis is the evidence it offers in relation to the National Bank of Serbia's (NBS) *legal* and *actual* independence and, relatedly, on the NBS's institutional framework in light of anticipated European Monetary Union (EMU) membership. Additionally, our work appends the existing perceptions about the NBS's roles and monetary policy in transition through an identification of its phases and corresponding results. It does this by analysing the pre-transition period as well as the country's economic and monetary transformation by focusing on the central bank institutional achievements from mid-1989 to mid-2003. The result should be better understanding of economic and monetary factors, which stood behind the protracted secular decline that Serbia experienced during the 1990s (see Palairet, 2001).

Consequently, an originality of this study lies in its scope. While other existing studies relate to specific aspects of monetary transformation period, analysing only isolated episodes (e.g. Petrović and Mladenović, 2000), they fail to offer a global view. On the other hand, many studies analyse the entire reform of the financial or banking system in transition, but do not explore the specifics of transitional monetary and central bank institutional issues (e.g. Thorne, 1993). As in the context of development economics, sound monetary policy and accompanied transparent central banking are seen as the main prerequisites for an increase in public confidence and secured price stability. Without these two elements, neither Serbia nor the Western Balkans will ever achieve growth and prosperity (see Gligorov, 2000).

1.2. Rationale of the Study: Old Lessons for New Challenges

Sustained economic growth has been the main driving force behind many institutional or even constitutional changes in different parts of the world. One could argue that, in economic terms, the probability of achieving higher sustained growth was the most compelling feature of the market-oriented economies of Western Europe, which attracted the previously centrally planned economies of Eastern Europe, to begun their respective *transition*. The transition started once the communist parties faced a downfall of their system and their rules, symbolically associated with the fall of the Berlin Wall in 1989.[3]

In its narrow sense, the term transition is defined as "the process or a period of changing from one state or condition to another" (Hornby, 1995, p. 1270). In relation to the historic economic changes, which took place during the 1990s in the countries of the ex-Soviet block, the term transition is generally used to mark the *process* of transformation from centrally planned to market economy. Similarly, Calvo and Frenkel (1991, p. 269) use the term to define the transition *period* during which "the old central planning system is dismantled (or collapsing), while the new market system (and its associated institutions and policies) is still not in place". Some authors[4] do question the appropriateness of such a term in situations in which not even a basic institutional infrastructure known to market economies had existed in previously centrally planned economies. In such cases, these would need transforming, like in the case of capital markets. To those authors, the term 'building' seems to describe the reality more correctly.

The countries that embarked on the path of transition were many, and they have been differently grouped by various authors and institutions due to their geographical position, historical connections or economic performance. For the purpose of our thesis, and based on principle of regionalism, 27 transition countries are grouped as follows:

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[3] Lipton and Sachs (1990, p. 87) argue that "the collapse of communist one-party rule was the sine qua non for an effective transition to a market economy. If one proposition has been tested by history, it is that the communist parties of Eastern Europe would not lead a process of radical reform sufficiently deep to create a real market economy".

[4] See Zec and Živković (1997, p. 123).

- Central East European (CEE) countries: the Czech Republic, Hungary, Poland, Slovakia and Slovenia;
- Baltic States: Estonia, Latvia and Lithuania;
- Commonwealth and Independent States (CIS): Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, the Russian Federation, Tajikistan, Turkmenistan, Ukraine and Uzbekistan;
- South East European (SEE) countries: Bulgaria, Rumania and the Western Balkan, and
- Western Balkan: Albania, Bosnia and Herzegovina, Croatia, Macedonia and Serbia and Montenegro.

All these countries and regions had reached different stages of economic transformation by 2004 and some of them had even completed their transition processes.[5] Namely, all CEE and Baltic States, by entering the EU, should have attained the status of market economies.[6] The argument behind this reasoning is that these countries were asked to fulfil the so-called 'Copenhagen criteria' before joining the Union. The *Copenhagen criteria* were set by the EU heads of governments at a meeting in Copenhagen in 1993 and laid down the basic conditions for EU membership:

- Existence of a stable institutions guaranteeing democracy, rule of law, respect for and protection of human rights and minorities;
- *Existence of a functioning market economy, capacity to cope with market forces and competitive pressures within the EU* [auth. remark], and
- Ability to take on the obligations of membership, including economic and monetary union (Pelkmans, 2001, p. 383).

[5] See Bofinger and Wollmershaeuser (2000, p. 3).
[6] See Pelkmans (2001, p. 383).

Having in mind, though, that EU membership also depends on many political considerations, the economic and institutional achievements of those countries can be put under query. Nevertheless, we are ready to assign to interpretation advocating that the transition in these countries is over, based on criteria suggested by Sahay and Végh (1995, p. 19). According to them, the transition ends once the pressures arising from structural inefficiencies and constraints, which they impose on monetary and fiscal policies, are removed, as they have been in those countries.

Additionally, one could argue that those countries need no prolonged *transition period*, but an enduring *convergence period* in order to align their economic performance to the so-called 'Maastricht criteria' or to the EU level of per capita income. The latter is an argument forwarded by Köhler and Wes (1999, p. 11) who argue that the real convergence in terms of per capita income "is likely to take much longer than meeting the Maastricht criteria". Nevertheless, the *Maastricht criteria*, established by the Treaty of Maastricht in 1992, remain the main formalised convergence criteria for further European monetary integration:

1. *Price stability*: the rate of inflation, observed over a period of one year before the examination, may not exceed the average rates of inflation of the three EU member states with the lowest inflation by more than 1.5 per cent;
2. *Interest rates*: long-term interest rates shall not vary by more than 2 per cent in relation to the average interest rates of the three EU member states with the lowest interest rates;
3. *Deficits*: national budget deficits must be close or below 3 per cent of GDP;
4. *Debt*: debt is not explicitly mentioned in the document, but it is considered that public debt may not exceed 60 per cent of GDP;
5. *Exchange rate stability*: a national currency shall not devalue during the two previous years and must have remained within the Exchange-Rate Mechanism II (ERM) ±15 per cent margin of fluctuation (El-Agraa, 2001, p. 143).

It should be stressed, though, that these criteria do not represent a precondition for EMU membership[7]. Rather, they are seen as an indicative set of macroeconomic policy guidelines for some existing and possible future EU member states, including the SEE countries wishing to join the EMU. Even thought ambiguous, the significance of these criteria stays strong and ostentatious. The importance of the Maastricht criteria for our study lies in the fact that those criteria frame the scope of monetary (and fiscal) policy choices of any prospective government that would wish to take Serbia into the EU.

Starting from the proclaimed aim of the SEE countries that their ultimate goal is to become an E(M)U member, and that the EU represents the biggest trading and economic partner for all transition countries remaining outside the EU[8], there is no doubt that the Copenhagen and Maastricht criteria set up by the EU will continue to influence these countries' transition processes in the years ahead. Therefore, any investigation over the various modalities of achieving stated monetary and fiscal objectives during the upcoming years of transition of the SEE and Western Balkan countries should be welcomed, as it could reduce the possibility of failure.

Within the mentioned scope of subjects, however, further elucidation of monetary issues and its accompanying central bank institutional developments deserve particular attention, as they pose an immediate, but also a continuous challenge to the domestic authorities. Thus, our work pays particular attention to these two features. The theoretical background for exploration of the monetary and central bank institutional themes is given, at least, by the following several academic disciplines: transitional economics, development economics, (new) institutional economics, (new) political economy, and monetary economics. Consequently, our work is mostly, though not entirely, framed by theories belonging to these academic approaches.

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[7] "Although participation in EMU is not a formal requirement for EU membership, candidates for accession will be expected to adopt the *acquis communautaire* of Stage 2 of EMU, including convergence toward EMU reference values and adherence to the new exchange rate mechanism (ERM2) created for non-participating EU members" (Kopits, 1999, p. 37).

[8] According to Bishev (2000, p. 29) "the countries of South-East Europe belong to Europe not only in normative terms but also in economic terms. The European Union is the largest trading partner for the region as a whole as well as for each particular country. Trade with the EU-15 accounts for 30.7 per cent of the region's GDP or 53.8 per cent of its total world trade".

Transitional Economics, probably, is the most broad among them. From the point of view of transitional economics, the role of monetary policy in transition has been recognised at the outset of that process. Early works by Lipton and Sachs (1990), McKinnon (1991), Calvo and Frenkel (1991), Fischer and Gelb (1991) and others, however, only anticipated monetary policy as a part of a broader set of macroeconomic measures needed to support the more profound structural changes of economies in transition. The reasons underlining this approach lie in the inherited macroeconomic imbalances of former socialist economies and in the passive roles which money and credit played within that political setting. Consequently, at the beginning of transition, the emphasis was placed on macroeconomic stabilisation, as a set of immediate interventions in monetary, exchange rate and fiscal spheres. The theoretical foundation for such an approach toward the transitional economics is found in the 'Washington consensus', a term coined by Williamson (1990).

Originally, the *Washington consensus* referred to a minimum agreement over economic policy reforms, as proposed by "Washington" toward the Latin American countries during the 1980s. According to Williamson (1990, p. 1) "the Washington of this paper is both the political Washington of Congress and senior members of the administration and the technocratic Washington of the international financial institutions, the economic agencies of the US government, the Federal Reserve Board, and the think thanks." The consensus includes the following ten economic policy instruments:

- "Fiscal discipline
- A redirection of public expenditure priorities towards fields offering both high economic returns and the potential to improve income distribution, such as primary health care, primary education, and infrastructure
- Tax reform (to lower marginal tax rates and broaden the tax base)
- Interest rate liberalization
- A competitive exchange rate
- Trade liberalization
- Liberalization of inflows of foreign direct investments
- Privatization
- Deregulation (to abolish barriers to entry and exit)
- Secure property rights" (Williamson, 2000, p. 252).

Both, the term and the concept of the Washington consensus have been extensively debated during the 1990s (see, for example, Stiglitz, 1998, and Kodolko, 1999). Consequently, Williamson on many occasions revisited the subject.[9] The proposed set of policy instruments Williamson (1999, p. 1) alone qualified as the set of reforms aiming at "macroeconomic stabilisation, microeconomic liberalization, and opening to the outside world". Many others, however wrongly or rightly, have used the term Washington consensus as a synonymous to 'neoliberalism', 'globalisation', 'market fundamentalism' and 'new (American) imperialism'.

While the transition economics literature has been more concerned with questions like what and how is to be transformed, the *Development Economics* opus has been approaching the issue of transition as a means of achieving sustainable growth in CEE, arguing that it is a precondition for development. Indeed, the Washington consensus has most often been questioned on the grounds of neglected development goals that could be achieved through the introduction of sound financial regulation, competition policy, transfer of technology and the encouragement of transparency (see Stiglitz, 1998).

From the monetary point of view, however, the restoration of growth can only be achieved after a reduction in interest rates, which measures the cost of price stability. Additionally, according to Bishev (2000, p. 22), cuts in interest rates seem feasible only when institutional confidence is established and when the low rates of inflation became permanent. As a result, the strengthening of the institutional (monetary) set up of transitional economies came under the scrutiny of the *New Institutional Economics*[10] theoreticians soon after the period of transition stabilisation was over. Their concerns rest with the 'informal constraints' underlying transition process.[11]

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[9] See Williamson (1999, 2000, 2002 and 2004).

[10] Douglass C. North, who is considered to be one of the founders of the new institutional economics, defines institutions as follows: "Institutions are the rules of the game in a society; more formally, they are the humanly devised constraints that shape human interaction. [...] A set of political and economic institutions that provides low-cost transacting and credible commitment makes possible the efficient factor and product markets underlying economic growth" (North, 1997, p. 2).

[11] This is how North (1997, p. 16) perceives the situation in transition economies: "The Eastern European demise of communism in 1989 reflected a collapse of the perceived legitimacy of the existing belief system and consequent weakening of the support organizations. The result was the destruction of most of the formal institutional framework, but the survival of many of the informal constraints. Policy makers were confronted not only with restructuring an entire society, but also with the blunt instrument that is inherited in policy changes that can only alter the formal rules but cannot alter the accompanying norms and even have had only limited success in inducing enforcement of policies".

The *New Political Economy*[12] scholars hinge on institutional issues, notwithstanding the fact that they engage heavily in the debate on the speed of transition[13]. Some of the main themes of this economic discipline are distributional considerations, institutions, and asymmetric information, which play an important role in public policy choices. Along these lines of research, the new political economy has devoted special attention to "motives and constraints of the monetary policymaking authorities, which are often (though not exclusively) central banks" (Cukierman, 1992, p. 1). Central bank independence, credibility, transparency and accountability are subjects placed at the core of this school. By using sophisticated game theory models, economists could eventually talk about the central banking problems in an analytical way.

All along the transition process, *Monetary Economics* has also played a role in explaining the mechanisms behind the monetary and central bank transformation of the ex-socialist countries. Studies of interest rates, exchanges rates, monetary aggregates, monetary policy, and the actions of central banks, banks and other financial institutions, have proved to be equally intriguing for transition economies as they have been for the developed economies. Its main theories have been searching for monetary models that would support both: the economic longings of transition countries towards the desired EMU monetary model and enduring monetary stability such as euroisation, currency board arrangements, etc.[14]

Engaging in an extensive literature review in the course of our research has strengthened our belief that it would be naïve to expect any complex subject such as the transition from a centrally planed to a market economy, or any of the sub-topics deriving from it, to be explained exclusively, by just one of the many existing economic theories. Although we have chosen to present them separately, it is beyond question that all these

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[12] "The feature that distinguishes the new political economy from its older counterpart [Political Economy, auth. remark] is mostly methodological. In both instances economic and political behaviour are studied jointly, and the two-way interaction between them is put at center stage. But the new political economy utilizes modern tools and concepts from economic theory, game theory, and econometrics and merges them with recent insights from political science" (Cukierman, 1993, p. i).

[13] Roland (1994) provides a comprehensive overview of political economy arguments and political constraints affecting the speed and sequencing of transitional reform.

[14] For example, Masson (1999, p. 2) notes that "even before joining the EU, countries negotiating accession may feel that they can improve their chances of a successful outcome through showing that they are good Europeans by pegging to the euro, or in any case orienting their monetary policies around a euro-based exchange rate target.

theoretic approaches and different scientific disciplines frequently interact, relying on each other's findings. It is for this particular reason, that this work is framed by the several theoretical approaches mentioned above. The institutional developments of the monetary policy framework in Serbia during the transition, as the main subject of this work is, nevertheless, also bounded by the formal Copenhagen and Maastricht criteria mentioned earlier. It is these two sets of academic and regulatory features that establish the context for our further analysis and respective conclusions.

1.3. Significance of the Study: New Monetary and Central Bank Framework

The process of transition from a centrally planned to a market-based economy is an extraordinary socio-political and economic event. As such, the transition process has been catching the attention of economists, both academics and practitioners, from all around the world. Pioneering works, as we shall document in the following chapter, have mainly dealt with general transitional issues such as the scope and speed of transition. Later works, however, provoked numerous researchers to attach importance to various aspects of the transformation process such as privatisation, financial system transformation, trade liberalisation, labour relations, etc. Within the framework of each particular topic, scholars further opted to investigate the subject either in the case of a particular country (country studies), or on a certain group of countries (comparative studies), or to take a more general approach.

Unfortunately, mainly due to political reasons, Serbia was left out of the opus of transitional economics for many years as a transitional country. The country was neither treated as a case study, nor was it included in comparative studies. Three events have contributed greatly to this occurrence: (i) the quarrelsome break-up of the former Socialist Federal Republic of Yugoslavia at the end of the 1980s and the first half of the 1990s, (ii) economic and other sanctions that were imposed on the country by the international community in the period between 1992 and 2000, and (ii) the NATO foray, which followed the Kosovo conflict that took place in 1999. As a result of these political episodes, Serbia experienced some other country-specific events.

The first, economic one, was a hyperinflation of 1992-1994, of a magnitude not known to other European transitional economies.[15] The second, political one, was the democratic revolution of 5 October 2000; a delayed dismissal of an autocratic and totalitarian regime like those that ceased to exist in other transitional countries during the 1990s.[16] Still, Serbia's troublesome monetary record during the transition years appears to be the major economic specificity of the country, though not the only one. From a phenomenological point of view, we find it interesting to analyse how a country with a long tradition of central banking[17] had lost its historical advantage and fall into such severe crisis at the end of the 20th century. The political and economic episodes that we have already mentioned played a role in the country's poor economic performance during the 1990s (see Palairet, 2001). We also believe that the causality between these elements may explain why a country which first started the transition[18] is 15 years after left behind by other countries by so much.

Among particular questions to be answered in the study are: (1) what are the main features of the transition process in Serbia; (2) how have the transition countries, including Serbia, developed their monetary policy framework as a policy response to transition; (3) how well have been the applied monetary policy frameworks of transition

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[15] Petrović *et al.* (1999, p. 336) note the following: "The Yugoslav [Serbian, auth. remark] hyperinflation of 1992-1994 was historically unique and significant due to its extreme peak and duration. At its peak, in January 1994, the monthly inflation rate reached 313 million percent, thus becoming the second highest recorded rate of inflation after the Hungarian hyperinflation of 1945-1946. In addition, the Yugoslav hyperinflation lasted 24 months so that, after the Russian hyperinflation in the 1920s which lasted 26 months (Cagan, 1956), it is the second longest ever recorded".

[16] "Tough it was an authoritarian state, Yugoslavia [Serbia, too, auth. remark] had had no shortage of competitive elections since the collapse of communism in the late 1980s" (Birch, 2002, p. 500).

[17] The National Bank of Serbia started operating for the first time on 2 July 1884 (see Šević, 1996, p. 8). Apart form the oldest Bulgarian National Bank established in 1879 and National Bank of Romania established in 1880, the National Bank of Serbia was among the first central banks in Eastern Europe.

[18] Gros and Steinherr (1995, pp. 316 and 319) argue that "the first comprehensive and innovative programme for stabilisation and reform was the Polish ('Balcerowicz') plan of 1 January 1990" and that "Yugoslavia's stabilisation plan of 1 December 1989 was much less comprehensive as Yugoslavia already enjoyed a more decentralised economy". The authors diminish the importance of the Yugoslav stabilisation programme on the following grounds: "At any rate it [the stabilisation programme, auth. remark] was quickly aborted by republican disputes", an argument, which, although true, does not seem to be entirely relevant. On the other hand, Sahay and Végh (1995, p. 34) recognise the right order of appearance of stabilisation programmes: "The two earliest exchange rate based programmes were that of the former Yugoslavia (December 1989) and Poland (January 1990)". Bruno (1993, p. 209) also notes the following: "The comprehensive programme that was finally launched in December 1989 included a wide set of measures in the area of fiscal, monetary, trade, payments, and income policies, as well as a currency reform (four digits were struck off the old dinar) and the beginnings of structural reform in the enterprise and banking sectors".

countries in relation to their anticipated E(M)U membership; (4) what are the specific institutional determinants underlying the central banking transitional experience of Serbia and other transitional countries, and (5) how the monetary policy framework should develop in the future if Serbia and other SEE countries are to join the E(M)U. To put it simply, the central question that this study poses relates to institutional considerations, which have determined the choice of monetary policy framework in transition economies of Eastern Europe in general, and of Serbia in particular, in the light of their subsequent E(M)U membership. Within this research context, this thesis pays special attention to the NBS' independence, as an element of institutional central banking structure, and its relation (if any) to the economic policymaking.

Therefore, the significance of this study lies in the fact that it brings together Serbia's 15-year transitional monetary experience and the latest findings on the central banking independence issue, enabling an "insight into a prime influence on the systems' decision-making", as Houben (2000, p. 1) puts it. Theoretically, the study represents a contribution to transitional economics literature from the (new) institutional economics and (new) political economy perspective. As a remarkable case study with respective remarkable monetary policy episodes, Serbia's transitional monetary policy and corresponding central bank institutional achievements, which we deal with in this study, may offer something more to the theories that come under the headings of various academic disciplines. The study will certainly bring Serbia back into the researcher's focus where, as a transition country, belongs.

More practically, we believe that this work may serve individuals and institutions interested in understanding the transition process in Serbia, whether they be academic or business oriented. The analysis may also inspire further research in the area of institutional central banking developments, either within a single-country or within the bounds of a broader regional model. Additionally, we hope that this study shall provide monetary policy makers with a specific analytical tool in the formulation of their decisions and policy actions. Finally, this work may become a channel for rising public awareness over delicate issues such as central bank independence, accountability, credibility and transparency.

1.4. Methodology and Organisation of the Study

In principle, the literature on transition may be divided in two parts. On the one side, there exist numerous empirical, econometrical studies. On the other side, there are various analytical, qualitatively oriented works. From the point of view of social science, both of these collections are considered equally valuable in relation to the contribution they make to understanding the transition process and its accompanying effects. These two groups of studies, however, differ in the methodology they use and, consequently, in the type of data which they employ; the empirical studies are based on quantitative, statistical data, while qualitative works rely on the descriptive, qualitative data.[19] One should be aware, however, that the quantitative data on ex-socialist economies and their performance cannot be taken at face value. Lipton and Sachs (1990) were among the first to stress this.[20] The situation with the statistical data in Serbia does not deviate from this general picture. Therefore, we opt to use qualitative data, even though we are aware that this exhibits certain drawbacks, as well. According to Arksey and Knight (1999, p. 6), "qualitative data are notoriously hard to analyse and the conclusions drawn from the data are more obviously open to criticism than those from quantitative surveys", and qualitative data "cannot be easily put into categories or simplified".

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[19] For a more profound explanation between the two types of data see Arksey and Knight (1999, p. 6).

[20] What Lipton and Sachs (1990, p. 78) call 'the tyranny of misleading data' describes the following few cases. *Firstly*, it relates to the cases when there is a lack of high-quality statistical data, either because this data was faked for some reason by the communist regimes, or due to applied inadequate methodologies. *Secondly*, according to the authors, the term also describes the situation of a shortage economy, which was the case for all socialist economies, where "measures of living standards [...] are likely to contain a serious upward bias" (Lipton and Sachs, 1990, p. 79). In other words, what can be a fall in the standard of living in a market economy due to a fall in real wages, it can also mean a rise in leaving standards in a shortage economy due to the queues elimination, as fewer customers chase the same amount of goods. *Thirdly*, there is also a bias towards heavy industry, since the output produced does not represent real economic value, but rather just an input for further production. The main problem with the 'misleading data', however, according to the authors is that this data can produce unnecessary pressure on policy makers, thereby influencing their economic agenda. To all this, one may also add the fact that during transition process the very statistics authorities of transition countries also go through the stage of reorganisation and reformation of maintaining statistic records, and calculating certain macroeconomic and other parameters, something that they did not do before. The most obvious example is that statistics offices of former socialist economies were not 'used to' measure the private sector share in the output, since this sector was almost inexistent in the planned economies. There is also another problem; mistakes in grasping the unofficial economy, residing in the so-called 'grey' (legal), or 'black' (illegal) zones.

In particular, this study relies on a wide range of primary and secondary qualitative data collected until end-July 2005. The *secondary data* was gathered from various books, journals, reports, periodical bulletins and magazines of specialised financial institutions and organisations, most of which were found in libraries and archive centres, but also in private collections[21]. A majority of those works are written in English, but relevant Serbian studies were also consulted during the analysis. [22] For the purpose of this thesis, the *primary data* was congregated from a set of semi-structured interviews, which we held over a four-year period, from 2002 to 2005. The one-to-one interviews that we had conducted were based on a specific thematic agenda and relevant key questions, which were pursued during the interviews. Keeping in mind that the semi-structured interviews are not suitable for wide coverage, we focused on a detailed work with a fewer interviewees.

Our sample size, thus, included only a limited number of Serbian high government officials like the finance minister, minister for privatisation, minister for international economic relations, assistant ministers and other senior officials such the National Bank governor, vice-governors and members of the securities commission. Our qualitative approach endeavoured to collect the interviewees' personal opinions about certain monetary and exchange rate policy issues, as well as other institutional and organisational central bank themes. The primary and secondary data that we collected during our field research are presented in a continuous, narrative manner throughout the study. As a result, some of the secondary data are disclosed in various tables and figures presented in this work. In such way, we put the data in the function of supporting the findings of this work, using it as a building block for our analysis and a constituent component of all our conclusions. Nonetheless, some of our data collection is also given in the appendices at the very end of this thesis.

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[21] An example of such private collection is the one belonging to Ms. Aleksandra Drecun, the Secretary General of the Presidency of the Republic of Serbia (2004-date) and the former Sectretary General of the Ministry of Finance.

[22] Most of the Anglo-Saxon literature was obtained from the London School of Economics Library, the British Library, the University of Greenwich Library and the University of Exeter Library, during several few-months visits, which were paid to the United Kingdom. Our fieldwork in Belgrade, Serbia, included numerous visits to the National Bank of Serbia Library, the Economic Institute Library, the Parliament of the State Union Library and the republic government's archive.

Even though we are aware of the fact that any transition also has its political and social elements, we believe that one study cannot grasp all the details of such a complex process. Our work, therefore, analyses exclusively the economic aspects of the transition process, with a special reference to monetary policy issues. The scope of this subject is potentially enormous, given the important interrelationships between monetary, fiscal and external policies and between the central bank as a major player in financial markets and banks or other non-banking financial institutions. Therefore, the study deliberately ignores, or treats only cursorily, issues like financial system reform, banking reform, central bank supervision and other related subjects that would merit separate and more detailed studies of their own. The emphasis is, instead, put on the institutional features of central bank and monetary policy reform in the process of economic transformation of a socialist system into a market-based system in general, and in the case of Serbia in particular.

The study is conducted on the basis of an ensuing plan. Following this introductory chapter, Chapter II reviews the transition literature in general and presents the academic papers on monetary and central bank issues in particular. The chapter also encompasses papers in the area of E(M)U membership requirements and corresponding theoretical models of accession. For the sake of clarity, papers are presented separately, as a combination of authors and topics' reviews, whereas the conclusions are drawn through a cross-reference basis for each particular section. The main conclusions are that a broad political and social consensus about the global reform strategy is essential if the transition is to be successful and less costly, that the credibility of programmes and institutions is fundamental for a lucrative transition, and that an adequate legal framework remains the main mechanism for channelling the discretionary policies of economic decision makers.

Chapter III brings the most interesting and the most relevant features of Serbia's constitutional and economic legacy between 1947 and 2004, paying particular attention to the stabilisation programmes pursued in the period from 1989 to 2004 (e.g. the Marković and Avramović programmes). The chapter discloses the stop-and-go character of Serbia's transition, since December 1989. The lessons drawn are that: (i) real instead nominal democracy is needed for substantial reforms to be implemented, (ii) a complex

constitutional structure of a country does not necessarily represent an impediment to reforms if there exists a real domestic political *and* international support to reforms, and (iii) times of extraordinary politics, outside the scope of the collapse of communism, may serve as a catalyst for difficult reform tasks, though these periods remain relatively short.

Chapter IV looks at the role of monetary policy during a transition, underlying certain propositions, commonly accepted among economists, on what monetary policy can and cannot do in general. In relation to that, the chapter examines the use of nominal anchor(s) during the transition and raises the question of monetary policy conduct and the choice of monetary policy instruments during transition. Moreover, the chapter offers an analysis of the European prospects for the remaining ex-socialist countries of Europe by looking at the possible monetary policy framework that would be in line with envisaged macroeconomic convergence towards the Maastricht requirements. Finally, the chapter analyses different models of monetary policy strategy, which can be applied on the way to EMU (currency board arrangements and euroisation).

Having in mind the importance of an appropriate institutional set-up for monetary policy, Chapter V looks at the specific issues of central banking in Serbia in transition times (1989-2003). An analytical discussion is carried out with respect to the central banks' legal frameworks as a prerequisite for their institutional, personal, functional and financial independence. Most importantly, however, is that this chapter offers some evidence on the *legal* and *actual* National Bank of Serbia independence, thereby placing it into the broader historical and transitional context. Equally important is that the chapter develops an argument against the constitutional solution establishing a single-person central bank governing body, and an argument for institutionalised model of central bank transparency, as a means of increased central bank accountability and credibility.

By summarising the main finding of this thesis, Chapter VI concludes that the pure political scrutiny of central banking should immediately be replaced by an adequate systemic and analytical approach, in an attempt to restore the credibility of some of the oldest central banks in Europe, such as that existing in Serbia.

Chapter II General Theoretical Background

2.1. Introduction

Transition, as a concept deployed in our thesis, is clearly not an exclusive category reserved for European countries. China, being an Asian country, for example, has also undertaken a specific transitional experiment in the last several decades. Additionally, Latin American countries have tried to reform their economic systems over the last few decades, too. Still, we cannot say that the transition in Eastern Europe has fully followed these examples. The reason for this is that the Eastern European transition has been *different* from transition elsewhere. The question, then, is *why* has the transition in Eastern European countries differed from transition elsewhere?

Fischer and Gelb (1991, pp. 92 and 98) consider China's case as, indeed, a distinctive and very interesting. However, the authors doubt that China's rural reform, which stands as the most successful example of property rights resolution among socialist countries, could easily have been applied in the European transition countries. This was due to the fact that the Eastern European countries were heavily industrialised at the beginning of transition, while retaining a large proportion of agricultural sector.

Similarly, Fischer (1993, p. 392) argues that the transition in China is different from the transition in Eastern Europe due to the following four reasons: (i) the transformation in China started from the agricultural sector through the partial privatisation of 'communes' after 1978, (ii) industrial growth in China derived from newly established firms, not from state-owned restructured firms, (iii) macroeconomic stability was maintained throughout the transformation process, and (iv) political situation was kept stable, even though the regime was authoritarian. With respect to that, the author argues that the European transition countries differed in every respect from their Chinese rival since the countries in Eastern Europe had large industrial state-owned enterprises and small agricultural sectors, unstable macroeconomic settings, and much greater political instability due to the dissolution of their authoritarian regimes.

Regarding the Latin American countries, Bruno (1993, p. 203) recognises that there are certain similarities in the *objectives* and the *means* applied during the reform processes in both, the European and the Latin American countries. These similarities, according to the author, are twofold. Firstly, both groups of counties had an objective to open up towards the world and to adjust their distorted and controlled prices to world prices. The establishment and maintenance of macroeconomic stabilisation and internal and external balances appear to be another common objective. However, Bruno (1993, p. 204) concludes that the Latin American countries "differ from their Eastern Europe analogues in that their underlying structure is none the less largely market-oriented and private property rights are reasonably well defined".

Obviously, even though these historic examples might have not been fully applicable in transition in Europe, they exhibited certain elements, which could and have been used in the Eastern European countries during the transformation process. This was especially the case at the beginning of transition, during the stabilisation phase, when many lessons from Latin American stabilisation programmes were used in the formulation of the appropriate anti-inflation strategies of former socialist economies.[1]

2.2. From a Centrally Planned to a Market Economy

Gros and Suhrcke (2000, p. 17) find that the transition countries of Europe are special because they happen to be, even after ten years of transition, still characterised by a high proportion of industrial sector in the overall structure of their economies, a high level of energy usage compared to their per capita income, an extensive physical infrastructure, and a high proportion of secondary and tertiary educated individuals in their overall population. Most of these features of transition economies date from the socialist period. Therefore, the early works on economics of transition, as it will be demonstrated on the following pages, dealt with the inherited conditions as a context for the establishment and implementation of adequate transition strategies.

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[1] See the explanation about the Washington consensus in Chapter I of this thesis on page 7.

2.2.1. Socialist economies prior to transformation

According to Gros and Steinherr (1995, p. 41), the Socialist economic design was partly inspired by Marxist theory, and partly supported by the communists' decision to stay in power *via* the establishment of an institutional design based on the following three policy choices: national self-sufficiency, collective ownership, and rapid growth. Out of these three top policy priorities, growth acted as the paramount plan of the socialist economic blueprint, because only very high growth rates of output could secure the positions of countries' leaders promising to overtake the West in its economic performance.

At the same time, however, the central planners did not exercise any control over aggregate demand, the liquidity of the system, the distribution of revenues or the exchange rate. The authors argue that the limited role of money under socialism was inherited in the Marxist view of monetary exchange, which criticises the capitalist economy relaying on investments and profits, while it encourages the socialist economy advocating direct allocation and exchange of goods without monetary mediation. However, even though Marxist theory proposes that money should not be used, in reality, the "socialist countries have remained monetised" (Gros and Steinherr, 1995, p. 51). As a result, the transition inception period was characterised by a huge monetary overhang.

Gros and Steinherr (1995, p. 156) define money overhang within the concept of 'forced savings', as an amount that equals to an excess stock of cash or savings deposits. Even though there appear to be two aspects of forced savings – microeconomic and macroeconomic – it is only rational to talk about 'forced savings' from a macroeconomic (i.e. aggregate) point of view. Since in a centrally planned economy demand for goods is higher than the supply of those goods, on an aggregate level people are 'forced' to save, as they actually do not have enough goods to spend money on. Therefore, a mismatch between the wages and goods available for consumption appears to be the main cause of monetary overhang, the volume of which appeared to be quite difficult to estimate. The implications of such wrong estimations are of particular importance during the first years of transition, when price liberalisation takes a high place on the reformers' agenda.

Namely, it was important at the outset of transition to have numerical estimates of an expected jump in a price level after the price reform in order to be able to adequately accommodate the money supply. Bruno (1993, p. 219) finds that in the case of Poland and Czechoslovakia the forecasted price shock was 45 and 25 per cent respectively, whereas the actual price shock was 80 and 40 percent. Gros and Steinherr (1995) find that mistakes derived from the fact that the ratio of money to income, i.e. velocity of money, in transition economies, is quite variable and changes rather quickly.

The authors further explain that in terms of monetary flows, the socialist economic system was divided between a cash and a non-cash sector, where individuals and households used cash, while enterprises had only been using it occasionally, to meet payroll. Notably, cash was used for goods purchases in the majority of cases, while all transactions between the government, firms and central bank[2] contributed to the functioning of a non-cash sector. Under the scenario presented by the authors, money failed to represent a 'universal means of exchange', as it exhibited 'internal non-convertibility', which prevented the free flow of money between different sub-accounts of the same enterprise. Figuring such an integrated financial system with one public sector embodying all other sectors (government, central bank and firms)[3], Gros and Steinherr (1995, pp. 53 and 55) demonstrate another feature of a socialist economy; the net wealth of a socialist economy equals to net money supply held by households.[4]

Moreover, apart from the direct restrictions on free money flow in the case of micro-units, i.e. enterprises, in command economies there also existed indirect restrictions on money flow. Those are visible in the case of interest rates, which had not played a role in the allocation of financial resources within a socialist economy. As long as money just accommodated targets in the real sector of the economy, and financial flows just helped achieve these targets through the central credit plan, interest rates could have not been used as a policy instrument. The conclusion then emerges that *money* under socialism was not a policy instrument.

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[2] Central bank under socialism also performed a function of a commercial bank by allocating credits to firms and keeping the firms' accounts.

[3] The aggregation is made on the presumption of a classical socialist economy in which government owns all the firms and regulates the functioning of the so-called 'monobank' system.

[4] In a capitalist society, as a contrast, net wealth equals to money supply and government debt held by households and firms.

Lipton and Sachs (1990) were among the first to examine the structural aspects of the shortage economy of socialist countries and its implications on the anticipated reform strategies through the model of repressed inflation. They also touched upon the issues of Stalinist legacy and the sources of excess demand, as well as the inherited economic conditions in different transition countries and the transition strategy in general, and examined the case of Poland in particular.

According to these two authors, the main legacy of the Stalinist regime is the social ownership structure, which implies that a state owns the majority of industrial production and service sector, and that the private ownership is negligible. At the same time, the structure of socialist economies was such that it favoured heavy industry and neglected light industry and the service sector. This was due to the obsession with growth and intense trade relation with the Soviet Union as the main exporter of raw materials to Eastern European countries.

As a consequence, the business behaviour of state-owned enterprises in the socialist setting appeared to be problematic. The enterprises set wages on a basis of relaxed rules and were thus prone to pay excessive wages, while in the process of investment policy-making the enterprises' managers longed for large investments without a fear for investment failure. Such a situation was backed by the fact that the socialist system lacked adequate entry and exit procedures for enterprises. The investment initiatives were agreed directly between the enterprises, ministries and relevant planning authorities implying that the credit and capital markets in socialist economies did not perform an allocation function. Thus, the socialist economies suffered from distorted relative prices, which due to overvalued exchange rates led to high effective prices of imported goods.

The result was that all socialist economies exhibited a *chronic excess demand.* Excess demand was manifested in the form of a shortage of consumer goods at official prices, as too many people chased too few goods. At the enterprise level, excess demand was evident in shortages of basic inputs at official prices. However, a degree of excess demand was not the same for all socialist countries: in Yugoslavia the shortages of goods at official prices were far lesser than, for example, in Bulgaria, Poland or Romania (Lipton and Sachs, 1990, p. 85).

The authors attempted to explain the sources of excess demand by applying the model of repressed inflation. They argue that a rooted belief that monetary overhang was the main source of excess demand in socialist countries did not provide an adequate explanation since it deals with the *stock* component and can explain only part of the process. Other part of explanation derives from the *flow* effect, which means that the origins of chronic excess demand are deeply inherited in the socialist systems and include: obsession with the growth, the existence of soft budget constraints[5], 'autarkic production strategy',[6] etc.

The model of repressed inflation also emphases the following implications of a shortage economy. Firstly, it shows that in a demand-driven system real income and utility are directly proportionate, while in an excess demand economy this relationship is indirectly proportionate, i.e. rise of real income leads to a fall in utility. Secondly, the model demonstrates that excess demand leads to hoarding, increased corruption and distortions of a trading system. Thirdly, it shows that "the *sine qua non* of currency convertibility is the elimination of excess demand" (Lipton and Sachs, 1990, p. 96).

Consequently, the authors argue that such systemic distortions at the beginning of transition called for a *rapid* approach to reforms. They believe that the transformation should include three steps: (i) elimination of excess demand through macroeconomic adjustments, (ii) establishment of market competition *via* price deregulation, trade and private sector liberalisation, and (iii) privatisation. However, the authors underline that all these phases should be accompanied by the introduction of adequate labour market policies, new rules of wage and investments settings, and debt restructuring. It should be noted, though, that their work was greatly inspired by Kornai's (1990) learning.

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[5] The concept of 'soft budget constraint' was firstly introduced in 1980 by a Hungarian economist János Kornai in his work *Economics of Shortage*. Later on, in his paper *The Soft Budget Constraint* published in 1986, Kornai further cleared the meaning of the concept. In particular, Kornai (1986, p. 4) said: "The 'softening' of the budget constraint appears when the strict relationship between expenditure and earnings has been relaxed, because excess expenditure over earnings will be paid by some other institution, typically by the State". Kornai (1986, p. 9) deliberately avoided "an overly pedantic definition" of soft budget constraint, but rather referred to the notion of the soft budget constraint as to "a trend in modern society: the relaxation of financial discipline, the weakening of the feeling that spending, survival, expansion depend on earning capability and not on external assistance". According to him, soft budget constraints may take different forms: soft subsidies, soft taxation, soft credit, soft administrative prices and other, which are not mutually exclusive (Kornai, 1986, p. 6).

[6] Autarkic production strategy implies that all components for the production of a final good are produced by the same enterprise, thereby evading specialisation.

McKinnon (1991) systematically presents the basic monetary and fiscal mechanisms of a *classical* socialist economy, which operated on the following four fundamental prepositions: (1) government owns all industrial and agricultural property, (2) government determines the output *via* production plans, (3) government determines the prices, and (4) government limits wage claims. As a consequence, the system of taxation under socialism was largely *implicit* and uncodified, while the system of money and credit was entirely *passive* (McKinnon, 1991, p. 108).

The fiscal system worked on the basis of direct allocating enterprises' cash surpluses to state budget and the indirect taxation of households through the mechanism of workers' wage limits. Similarly, the monetary system functioned on a basis of carefully monitored enterprises' deposits held in state bank accounts, and households' currency in circulation that, nominally, were used freely. However, by an explicit control of enterprises' accounts and cash in circulation, the conversion of money from enterprises to households was controlled too, thereby complementing the system of wage controls.

McKinnon (1991) believes that in a transition it is necessary to introduce a new tax regime based on a value-added tax and personal income tax, and a new tax administration capable of administering such a novel system. The author bases his argument on the grounds that once liberalisation is initiated and government starts rescinding control over its enterprises, the tax base begins eroding. However, since immediate privatisation is not feasible at the outset of transition, a broad classification of enterprises according to their degree of liberalisation in a transition appears crucial: (1) transitional enterprises with remaining prices and output controls, (2) state-owned liberalised enterprises with freely set output and input, but with government control over wages, and (3) private liberalised enterprises with no direct government restraints.

Accordingly, McKinnon (1991) proposes a new system of money and credit consistent with the introduction of a new tax regime. His plan includes a two-stage process of financing liberalised enterprises. Stage one relies on enterprises' self-financing and the prohibition of bank lending to liberalised firms, thereby encouraging newly liberalised firms to use monetary assets as a store of value rather than physical assets, and helping the development of non-bank capital markets. A consecutive second stage relates to fully collateralised bank lending to the liberalised sector under commercial conditions.

Sahay and Végh (1995, p. iv) strongly argue that the most beneficial way to understanding the inflationary pressures of countries in transition is to examine the "inherited nominal instabilities of planned economies". Indeed, by applying their model they show that a Soviet-type command economy is characterised by the *endogenous* money supply and that the system as such is *overdetermined.* Money supply appears to be endogenous to the system since the current period money supply determines the next period money supply, under the assumption that the planned wage costs do not alter between periods. On the other side, the system happened to be overdetermined since there were two nominal anchors, i.e. planners set both prices and wages. Analogously, Sahay and Végh (1995, p. 3) conclude that monetary stability rests on the equality between the wage bill and the consumption of goods bought at official prices.

It follows that any change in the price or wage levels would lead to inflationary pressures. Namely, since any increase in wages could be fully accommodated by simply printing money, money supply would increase too, producing higher inflation. Moreover, by adjusting their model to different scenarios, the authors find that any temporary increase in nominal wages led to a permanent increase in the money supply and to a permanent monetary overhang. Similarly, any permanent increase in the level of nominal wages induced an 'ever-increasing' money supply and, consequently, an 'ever-increasing' monetary overhang. Thus, stabilisation in command economies could have only been achieved through a combination of monetary reform (a reduction in the stock of money) and an upward adjustment in official wages. In particular, by affecting the level of wages by either allowing direct credits to the state enterprises *via* the state bank, or by granting subsidies *via* the state budget, money supply was regulated too. By using these mechanisms, the socialist economies managed to eliminate monetary overhang immediately. However, when the transition process triggered the price liberalisation – introduced after a period of repressed inflation – the result was a price level *overshooting*[7], only then followed by a period of price stability. Yet, the mechanism worked only in cases in which wages remained as a nominal anchor. In situations in which neither prices nor wages were used as nominal anchors, the economy as a whole turned to be highly unstable (Sahay and Végh, 1995, p. 16).

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[7] The term overshooting implies a depreciation of exchange rate due to the price and trade liberalisation.

2.2.2. Theory of economic transition

In theoretical terms, Kornai (1990) paved the way to a wide debate on the transformation of socialist command economies into the capitalist[8] market economies. His work "The Road to A Free Economy" inspired many (see, for example, Lipton and Sachs, 1990) to start scrutinising this topic further. Kornai (1990), however, build the theory of economic transition around the issues of ownership structure, macroeconomic stabilisation and political considerations relating to it.

Regarding private ownership, Kornai (1990) sets forth six preconditions for the development of private sector: (1) whole and true liberalisation, (2) law enforcement, (3) security of private property, (4) encouraging tax system, (5) amplified credits, and (6) increased social respect for private entrepreneurs and investors. On top of these formal attempts aiming at liberalisation, which depend on the state administration, the private sector appears to develop by itself, spontaneously, along the lines of the market (see Kornai, p. 36). However, the author underlines that these changes do not happen overnight, and that time is needed for the *gradual* development of private sector to actually take place.

In the meantime, until the private sector develops, the state sector remains dominant. But, it should not, according to Kornai (1990, p. 62), be equally liberalised. On the contrary, he argues that the state sector should be controlled even more tightly. The spheres of authority in which it is necessary to restrict the independence of state-owned firms are: credit usage, control of budgetary support, wages policies, investment decisions and selling procedures of state firms. And, business decisions such as determination of production quantity, selling prices, technology, engagement of labour force *et similar* should remain in the hands of state firms' managers.

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[8] On the margins of his work, however, Kornai (1990, pp. 44 and 45) points that "it is impossible to refer to 'capitalism' in general" and that whoever advocates for capitalism "should state more precisely what combination of liberalization and bureaucratic restrictions he has in mind" based on the grounds that "in some of the developed capitalist countries the intervention in the life of the individual and in the economic activity of private property is unnecessary frequent" and varies among countries. It should be noted, though, that the Kornai's argument, seen after 25 years, has lost much of its strength due to an increasing political and economic harmonisation between Western European capitalist countries and the accompanying clear prospects of the European Union membership for transition countries of Eastern Europe, streaming to adopt that particular – 'European' model – of capitalism.

Even though Kornai (1990) proposes the above measures, he does not believe that the state sector will become more efficient or fully replaced by the private sector, but that the 'dual economy' of private and state sectors will prevail. However, the set of restrictions directed towards the state-owned firms should help achieve two goals: (i) the protection of private sector, and (ii) macroeconomic stabilisation. In this respect, the author stresses the fact that the supervision role of national parliaments and institutions like central banks during transition become indispensable, as they counterweight the state administration.

Regarding macroeconomic stabilisation[9], however, Kornai (1990, p. 102) argues in favour of the *simultaneous* implementation of the following components of the programme: inflation stopping, restoration of budgetary equilibrium, management of macrodemand, formation of rational prices, and the introduction of a uniform exchange rate and convertibility. He also suggests that the authorities undertake these actions in a short, one-year period and that they explain them to the general public all along the way.

The gist of stopping inflation is rooted in the recognition that inflation is not a natural disaster and that the inflationary process, fuelled by inflation expectations and by government tendencies to finance large budget deficits, must be terminated. Kornai (1990) suggest that this exercise be done with the help of a radical reform of tax system[10] in order to ensure the collection of budget revenues sufficient to finance necessary budget expenditures. Additionally, the author believes that the whole operation must rely on the management of macrodemand *via* strict supply of bank credits to loss-making state-owned firms, solid control of interfirm lending, and tight wage discipline in those firms.

Finally, he proposes that the stabilisation programme includes the formation of rational prices through total liberalisation of all private and state sector prices (with only a few exemptions), conditioned upon the level of price liberalisation prior to stabilisation, and the level of supply and reserves of essential goods. For this to happen, however, according to Kornai (1990, p. 155), it is also important that foreign trade be liberalised, uniform exchange rate applied and domestic currency convertibility established. Moreover, he suggests that all these measures be taken concurrently and *radically*.

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[9] Kornai (1990, p. 102) dubs macroeconomic stabilisation as 'surgery for stabilisation'.
[10] In general, Kornai (1990, pp. 117-135) proposes that the new tax system become simple, neutral, non-progressive and non-counterincentive.

Fischer and Gelb (1991) devote their work to the analysis of initial conditions for reform, the elements of reform such as macroeconomic stabilisation and control, price and market reform and enterprises reform, and the sequencing of reforms. They argue that after the collapse of central-planning, different socialist economies exhibit varied degrees of (de)centralisation and macroeconomic imbalances, as shown in Figure 2.1. As a result, the reform challenges these countries had faced at the beginning of transition were not the same.

Figure 2.1. *Initial conditions for the socialist reform process*

	Low	**Degree of economic centralisation**	**High**
Little			
Internal and external macroeconomic imbalances	* Hungary		* Czechoslovakia
	*SFR Yugoslavia		* USSR * Bulgaria
Severe	* Poland		

Source: Fischer and Gelb (1991, p. 93).

What is striking about this figure is that SFR Yugoslavia was by far the most decentralised country, with severe macroeconomic imbalances at that time. This condition, in turn, made it difficult for the country to start structural reforms in line with a stabilisation programme. A similar situation was registered in Poland, while countries with less severe macroeconomic imbalances, such are Czechoslovakia and Hungary, had been advised to focus on structural reforms.

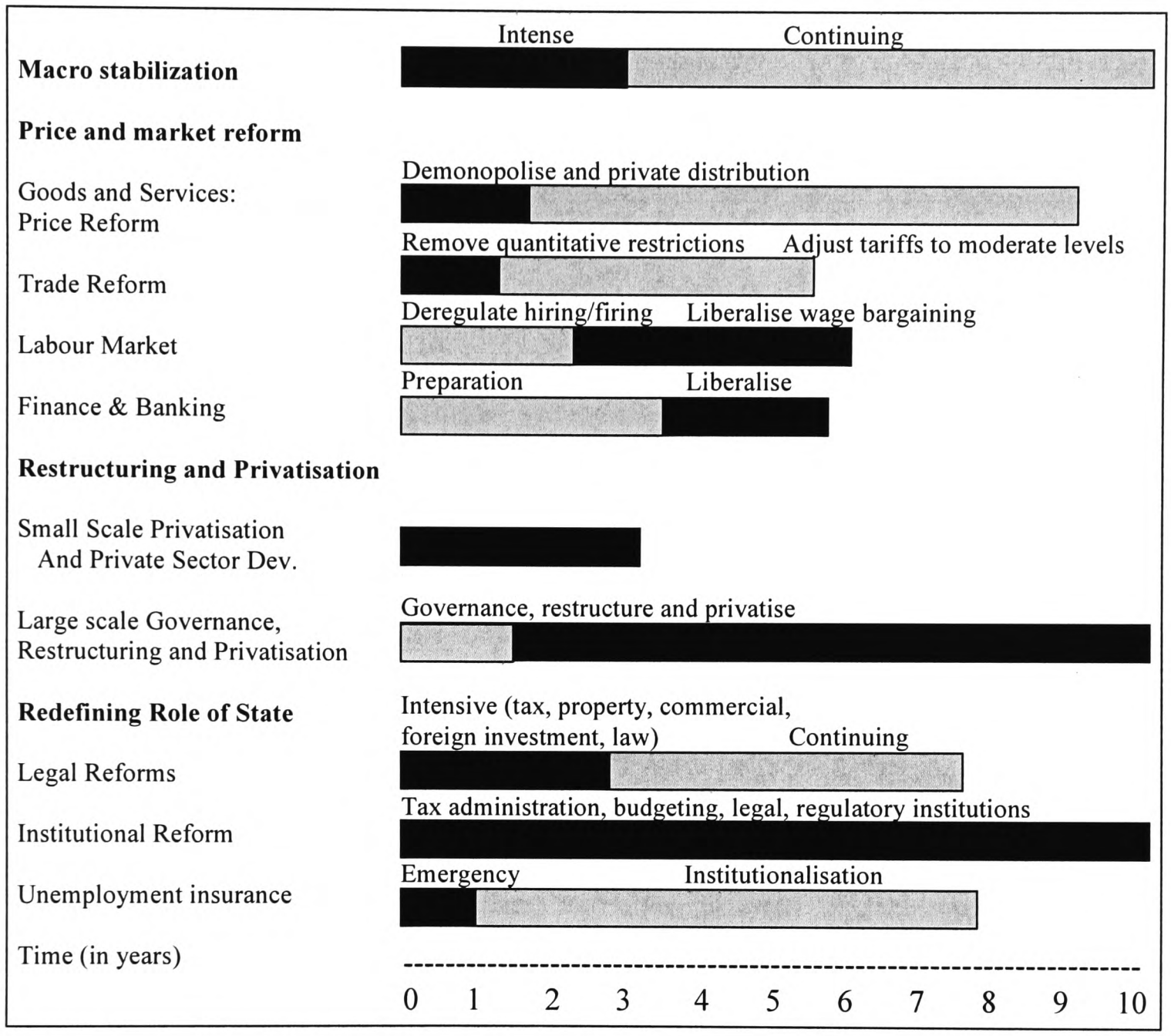
Although decentralised economies tend to begin the transition with an advantage, according to Fischer and Gelb (1991, p. 93), these countries need to further foster enterprises' market behaviour either through the elimination of cross-subsidies or through privatisation. On the other hand, the more centralised economies face the problem of defining clearly the ownership rights and assigning them to enterprises' outsiders. In each case, however, a political and social consensus is deemed necessary.

Macroeconomic instability, which occurs because of non-existence of bankruptcy laws and hard budget constraint practices in transition countries, should be tackled before structural changes take place. In particular, macroeconomic adjustment should focus on the elimination of subsidies to loss-making enterprises, public sector wage controls and credit ceilings supervised by the central bank. In addition, stabilisation should include elimination of monetary overhang through the following measures: currency reform, inflation reduction, increases in interest rates and privatisation of state property.

The next phase of transition should, according to Fischer and Gelb (1991), include price and trade liberalisation. The authors see these two policy actions as means of creating the right incentives for profitable enterprises and exporters to conduct their business on market-based principles. Alongside price and trade liberalisation, domestic deregulation, demonopolisation, and labour and capital market liberalisation are also preconditions for successful systematic transformation. The core of the transition process, nevertheless, is privatisation, which should include not only enterprises, but also the banks. Moreover, the inauguration of a new role for the government, such as to support the process of transition by the establishment of a new legal environment, accounting and audit system, tax administration, social safety nets and other sustainable arrangements, should be installed together with all these changes.

Fischer and Gelb (1991, p. 101) conclude by saying that "a linear sequence of individual policy changes is not the right concept when considering comprehensive system reform". The authors provide a stylised model of possible reform phasing (see Figure 2.2), arguing that the speed of envisaged reforms hugely depends on political support, and stress the importance of Western governments' active role in transition countries through the provision of technical and financial assistance, debt reduction and opening of their markets to the goods, services and capital of transition countries.

Figure 2.2. *Phasing of reform*



Source: Fischer and Gelb (1991, p. 102).

Fischer and Gelb (1991) were among the first scholars to offer a certain transition agenda, even though it is clear that they argued against a non-linear sequencing of reforms. Instead, they advocated a dynamic *phased* reform strategy that assumed the implementation of complementing policy reforms: macroeconomic stabilisation, price and market reform, restructuring and privatisation, and an accompanying process of redefining the state's role. The success of these policy interventions, however, according to the authors, depends on initial economic distortion conditions, population support and the overall political conditions in each transition country.

Marer (1991a) chooses to open the discussion with the set of definitions including macroeconomic stabilisation/adjustment, structural-institutional reforms, economic liberalisation, enterprise restructuring, and transformation/transition. Later on in the work, however, the author focuses on particular problems of macroeconomic imbalances and the control of inflation, enterprises restructuring, fiscal policy and taxation, financial intermediation and currency convertibility in the transition economies. The author concludes by answering the question of whether Western experience is relevant for countries in transition.

"Macroeconomic stabilization (sometimes called 'adjustment') means bringing severe repressed or open inflation and unsustainable deficits in the budget and/or in the balance of payments under control" (Marer, 1991a, p. 39). As repressed inflation induces many undesirable effects such as further price distortions, increased market segmentation, bargaining and other economic costs, it should be eliminated at the beginning of transition. Monetary overhang as an anticipatory form of repressed inflation can be eradicated in several ways, as described in the previous section.

The transition itself, however, according to the author, also causes inflation by hardening budget constraints, price liberalisation, new wage policies, exchange rate depreciation, inflationary expectations, and new external shocks. Furthermore, the problem of controlling inflation in a transition is additionally burdened because of the threat of wage-push inflation is substantial, the banking system is underdeveloped, enterprises do not operate on market-based principles, and there is a queuing problem induced by delays in supplies. Therefore, only a *tight* monetary policy coupled with the 'draconian measures' of authorities can achieve results in bringing and keeping inflation down during a transition (Marer, 1991a, p. 43).

"Enterprise restructuring refers to actions taken to bridge gaps between current performance and what is required to become internationally competitive" (Marer, 1991a, p. 39). Since the tightening of monetary policy induces a week supply response of enterprises in the early period of a transition, enterprise restructuring is needed to spur the adjustment. Restructuring may take many forms, from a simple cleanup of balance sheets to layoffs and selling of firms to new owners. However, in each restructuring process, the state and new owners should have an active role.

According to Marer (1991a, p. 48) the fiscal aspects of transition relate to two main policy objectives: first, a reduction in the level of spending and, second, a lowering of the fiscal burden for households and enterprises. These policy objectives are, nevertheless, in all transition countries, restrained by high political constraints and, thus, difficult to implement in full. Moreover, the task is encumbered with the declining revenues due to the closure of loss-making enterprises and an increased need for allocation of budget resources to social safety nets, which during transition should accommodate large layoffs of workers and other needs of vulnerable society' groups.

The economies in transition are also put before the problem of insufficient households' savings that are to be further channelled into more productive uses, generating growth. The origins of negligible voluntary savings in transition lie in the negative real interest rates and absence of attractive financial or real assets in which households could invest. Also, having in mind that previously centrally planned economies inherited a weak system of financial intermediation the authorities in transition must focus on strengthening the financial sector. Marer (1991a, p. 51) argues that this problem can only be resolved institutionally by developing an attractive legal and regulatory framework that favours the flow of financial information, a revision of bank ownership, specialised financial institutions, competition, venture capital and equity markets.

In relation to the question of currency convertibility the author raises the following four policy questions: (1) what exchange rate regime, (2) what type of convertibility, (3) what timing, and (4) what exchange rate level are desirable during transition? However, the author does not offer any concrete answers, but rather briefly looks at various proposed alternative solutions and their advantages and disadvantages.

As for the applicability of other countries' experiences in transition countries, Marer (1991a) believes that at a high level of generalisation one can, indeed, talk about the particular relevance of Western experiences for transition economies. Emphasising that the EU's laws, institutions and policy orientations may be the best model-to-follow for transition economies of Europe, the author highlights the experience of Spain and Germany as two striking examples. And in a later paper, the author looks at different types of market economies in more detail.

Marer (1991b) analyses the three models of successful market economies: (i) the social market economies of Western Europe, (ii) the consumer-directed market economies like the one of the United States, and (iii) the administratively guided market economies such as that of Japan, in order to isolate their common qualities, which are to be attained by transition economies.

The model of social market economies like those of Western Europe, assumes the existence of private property and strong competition based on market principles. Nevertheless, this model of capitalism above all presumes a strong state commitment to sound monetary and fiscal policies, efficient health and education care, a solid infrastructure and housing system, accentuated environmental protection and a strong safety net for the unemployed and poor.

The main characteristics of a consumer-driven market economy correspond to the features of the US economic model. This model predominantly relies on strong market forces and large labour and capital mobility with only limited role of the state. Within this type of economic organisation, the focus is on every individual entrepreneur and his short-run economic incentives to acquire as much profit as possible, thereby producing growth. Legal framework discourages private savings and encourages spending, placing the consumer at the centre of attention. Much less attention is given to the growing needs of socially unprotected groups of society, although some job tenure programmes do exist.

An administratively guided market economy, in contrast to the US model, is rooted in large voluntary savings and investments, and a strong commitment to employment security. The model emphasises producers over consumers and workers through the close collaboration of government, business and trade unions. Together with the downward flexibility of wages and long-term protection of domestic market from foreign competition, these features contributed to Japan's spectacular economic success.

In his conclusion, Marer (1991b) emphasises these main qualities of successful market economies: rule of law, private ownership, competition and trade, sound currency, large savings, stimulating taxation, effective financial intermediation, sound infrastructure, protection of environment, and opportunities for individual fulfilment. According to the author, all of these characteristics are mutually interdependent and interact constantly.

Dornbusch (1991) investigates strategies and priorities for reform offering a particular agenda for policymakers in transition countries. That agenda includes seven sequences: 1) inauguration of new rules of the game (unrestricted private ownership and entrepreneur freedom), 2) institution building (legal system protecting private ownership, functional courts, new accounting, pension and tax systems, unemployment compensation scheme, effective bankruptcy mechanism, etc.), 3) establishment of macroeconomic balances, 4) privatisation, 5) foreign economic liberalisation, 6) integration with the world through trade not aid, and 7) financial reform. The sequencing should serve to avoid the consequences of the vacuum established in the transition from the old and new economic systems while ensuring government retreat from production and other economic decisions.

Additionally, the author argues that all reforms should be conducted in a *rapid* manner, and that there is no place for gradual changes in the process of Eastern European economic transformation. Having in mind that political tensions during transition may arise due to the limited citizens' patience and high reform costs, fast government action is highly recommended. Otherwise, those of which the government did not take care of and whom it 'left behind' will radicalise. Moreover, according to Dornbusch (1991, p. 171), "transition needs to be accomplished extremely fast because [...] the distance to go is far, and the task is overwhelming". Government, however, at the beginning of the transition, should concentrate on what is *essential*, not on what is *urgent*.

The disadvantage of a gradual approach to transition, the author claims, is that it may lead to further economic distortions, since the old system collapsed and there is no other system to replace it. As a consequence, it can be expected that all economic agents will act in their best interest, which can be realised on the black market. Moreover, the administrative capacity for gradual reforms does not exist, as argued by the author, as the existing bureaucracy does not have the capacity to carry out gradual approach. "Gradualism offers superficial appeal because it seems to take away the harshness of adjustment" Dornbusch (1991, p. 171) notes and concludes that gradualism is only appropriate if the costs of gradual adjustment appear to be lower in comparison to the costs incurred if a radical approach is followed.

2.2.3. Concluding remarks

Clearly, the complexity of the transformation process of previously centrally planed economies of Eastern Europe was widely recognised in academic circles. Also, the fact that such major economic change must be backed by a strong political and social consensus was highly appreciated by many scholars. Nevertheless, even though the general picture was drawn, specific transition strategies remained ambiguous. On the one hand, the majority of economists promoted a rapid approach, arguing that a long-lasting adjustment can lead to "populism, protectionism, and a prolonged macroeconomic crisis" (Lipton and Sachs, 1990, p. i). On the other hand, only fewer academics underlined that a newly desired system cannot be built over night since it incurred high transition costs that could only be met gradually (see Kolodko, 1999).

These opposing views, however, relate to the reasoning of secondary adjustment, whereas the two groups of scholars agree that the transition's primary task – macroeconomic stabilisation – should be done promptly, as initially suggested by Kornai (1990). The same stands true for liberalisation measures. The logic behind this notion rests on long-established distorted practices and the (macro)economic imbalances of socialist economies at the beginning of transition, as was explained by Lipton and Sachs (1990), Fischer and Gelb (1991), Kornai (1990) and others. One should bear in mind, however, that not all transition countries shared the same starting positions. In other words, not all countries inherited the same (macro)economic imbalances.

It is reasonable to believe that those initial conditions differed due to diverging degrees of deviations from the *classical* socialist model of central-planning.[11] This, in turn, influenced the design of particular transition strategies in those countries once the transformation process started. Most of our discussion in Chapter III actually hinges on this idea and shows that, indeed, the inherited characteristics of the *market socialism*, which existed in Serbia (i.e. Yugoslavia) prior to transition, in fact, determined the formulation and the design of its monetary stabilisation policy during the first years of transition, as well as the overall transition process that was implemented thereafter.

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[11] This argument is supported by the evidence from Yugoslavia, Hungary and Poland, which exhibited low degrees of economic decentralisation, as explained by Fischer and Gelb (1991).

2.3. Monetary Policy Issues During the Transition

After experiencing political opening towards the West and after the political U-turn took a place in the countries of Eastern Europe at the beginning of 1990s, major economic changes were triggered, too. Centrally planed system collapsed overnight; government' ministries and agencies stopped producing financial and other plans, thereby eroding the entire economic system. In such circumstances, it was first necessary to stabilise the economy.

Stabilisation, in its *narrow* sense, at the beginning of transition called not only for a change in the way money was perceived and deployed, i.e. monetary policy switch, but also for other economic ventures like price and trade liberalisation and the introduction of fiscal and income restraints. In a *broad* sense, stabilisation also included other policy actions such as privatisation, enterprise restructuring, strengthening the rule of law, etc. However, in this thesis, we refer to the stabilisation in its narrow, macroeconomic (monetary) sense, focusing on the four basic questions: why, when, how, and what was to be stabilised.

The first question considers the *motives* of stabilisation programmes in order to reveal why stabilisation was necessary. The answer lies in the fact that, at the beginning of a transition, the inherited economic variables were unstable. Namely, as we saw already, in a majority of transition countries, the initial macroeconomic conditions were such that the external balance of payments, inflation, excess demand, unemployment, exchange rate and budget deficits all needed some adjustment. Thus, these countries resorted to stabilising the macroeconomic variables first, necessary to establishing a basis for more profound structural reforms.[12]

The second question relates to stabilisation *objectives*. In its essence, the stabilisation phase refers to an attempt to stabilise the inherited macroeconomic imbalances. Herein, stabilisation needed to deal with fiscal and external imbalances as these were the main sources of excess demand in socialist economies (Begg, 1996, p. 19).

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[12] As Lipton and Sachs (1990, p. 99) put it: "Structural reforms cannot work without a working price system; a working price system cannot be put in place without ending excess demand and creating a convertible currency; and a credit squeeze and tight macroeconomic policy cannot be sustained unless prices are realistic, [...]".

The third question looks at the *timing* of stabilisation programmes, recognising that transition countries began their stabilisation at different times, as shown in Table 2.1. According to Begg (1996), who based his conclusions on findings made by Bruno and Easterly (1995), the stabilisation phase ends once inflation is brought down to 40 per cent per annum.[13] Bruno (1993), on the other hand, believes that the reference point should be an annual inflation mark of 20 per cent, as it corresponds to the post-stabilisation results achieved in the Latin American countries (Bolivia, Chile and Mexico) and Israel in the aftermath of their hyperinflations.

Table 2.1. *Monetary policy framework in transition countries*

Countries	Adoption of Stabilisation Program	Principal Nominal Anchor in Stabilisation Program	Newly Introduced Currency
Group 1: Fast Response*			
Albania	III/92	Money	No
Bulgaria	I/91	Money	No
Croatia	IV/93	First money, later exchange rate	Yes, II/94
Czech Republic	I/91	Exchange rate	No
Hungary	I/90	Money	No
Poland	I/90	Exchange rate	No
Slovenia	I/92	Money	Yes, I/92
Slovak Republic	I/91	Exchange rate	Yes, I/93
Estonia	II/92	Exchange rate (currency board)	Yes, II/92
Latvia	II/92	First money, later exchange rate	Yes, III/93
Lithuania	II/92	First money, later exchange rate (currency board)	Yes, II/93
Kyrgyz Republic	II/93	Money	Yes, II/93
Moldova	III/93	Money	Yes, III/93
Group 2: Slow Response			
FYR Macedonia	I/94	Money	Yes, II/94
Romania	IV/93	Money	No
Armenia	IV/94	Money	Yes, IV/93
Azerbaijan	I/95	Money	Yes, III/93
Belarus	IV/94	Money	Yes, IV/94
Georgia	III/94	Money	Yes, III/95
Kazakstan	I/94	Money	Yes, IV/93
Russia	II/95	Money	Yes, III/93
Tajikistan	I/95	Money	Yes, II/95
Turkmenistan	No targets as of IV/95	n/a	Yes, IV/93
Ukraine	IV/94	Money	Yes, IV/92
Uzbekistan	IV/94	Money	Yes, II/94
Mongolia	II/93	Money	No

Notes: * Countries adopting a stabilization program within the first two years of transition.
Source: De Melo and Denizer (1997, p. 25).

The most important question of *how* the stabilisation is to be carried out is analysed in the several most influential papers presented in the following few pages.

[13] Easterly (1996) extends this conclusion by defining the successful stabilisation to be over once inflation falls below 40 per cent annually, *for two consecutive years*. See also Cottarelli and Doyle (1999, p. 2).

2.3.1. Monetary policy response to transition: stabilisation

Clavo and Frenkel (1991) believe that there is no a 'master blueprint' for economic transformation and focus on the implications of anticipated price reform in the period preceding the reform: the *early* phase of transition. They developed a simple model of a centrally planed economy consisting of two components (asset market and goods market) in order to investigate the effects of private agent expectations about the evolution of exchange rates, asset holdings and aggregate demand.

Under the assumption that nominal wages are fully indexed to the domestic prices, the authors find that price reform *announcements* induce an immediate depreciation of domestic currency, followed by a jump in the nominal and real exchange rate, as well as a consequent reduction in demand for tradable goods implying an accumulation of foreign exchange. When price reforms are *implemented*, the opposite happens because domestic prices and wages rise suddenly, resulting in a sharp fall in the real exchange rate, which as a consequence has a rise in demand for tradable goods and a decumulation of foreign exchange.

However, as many economic reform programmes anticipated unindexed wages, the authors also look at the macroeconomic and income distribution implications of price reforms under such scenario. The conclusion is that there exists a direct relationship between the degree of wage indexation, currency depreciation and inflation, i.e. the higher the wage indexation, the larger the currency depreciation and the inflationary pressures.[14] Having in mind particular relevance of such effects to transition economies, the authors extend the model of anticipated price reform with the assumption of a tight, contractionary *credit* policy. A conclusion emerges that the supply, demand and portfolio effects are the main factors determining the creation of a credit policy in transition. "A credit crunch resulting in a sharp rise in both deposit and loan rates of interest may be especially damaging under the institutional environment prevailing in PCPEs [previously centrally planned economies, auth. remark]" (Calvo and Frenkel, 1991, p. 287).

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[14] Moreover, since a rise of inflationary pressures may lead to a credit crunch and a resulting reduction of working capital and output supply, the microeconomic problem of price subsidisation trough wage indexation may, in fact, transmit into a macroeconomic problem of high inflation

The mentioned institutional environment relates to a weak banking system and impaired pricing mechanism, which do not facilitate the separation of 'good' and 'bad' firms, thereby threatening to undermine the efforts made to reduce macroeconomic distortions by giving a rise to further microeconomic distortions. One way to offset the dynamic evolution of the anticipatory price liberalisation is to resort to the complex fine-tuning of interest rates. However, this strategy cannot be sustainable, as it can be quite costly and damaging to the transitional banking system and to enterprises. As a result, the credibility of authorities announcing policy actions can be weakened and the whole operation put under question. Instead, a focus should be placed on a quick implementation of price reform and on the development and strengthening of domestic credit markets and corresponding regulatory and supervisory systems.

The authors also consider three different ways of reducing a *liquidity overhang*, which they define as "a situation in which price liberalization and the removal of subsidies bring about a rise in the *measured* average price level" (Calvo and Frenkel, 1991, p. 290). The first way to reduce liquidity overhang is through an increase in the domestic currency deposits interest rate. However, due to the fact that in formerly centrally planned economies the banks, which are supposed to bear the costs of higher interest rates, are owned by the government, it is the government budget that needs to repay these increased costs applying new taxes. The second mechanism assumes a rise in the measured price level, which again is a tax on the real value of domestic liquid assets. The third possibility is to reduce liquidity either *via* direct confiscation (a monetary reform) or open market sales of assets. In any case, the full amount of monetary overhang is born by the private sector by means of increased taxation.

Even though Calvo and Frenkel (1991) conclude that the process of economic transformation is a long and complex one, they argue for a short pre-reform period and a quick implementation of a timely, although not necessarily a perfect, reform strategy. According to them, a comprehensive reform package should include the macroeconomic and structural reform measures adapted to each country according to its specific political and economic backgrounds. In designing and implementing of transition strategy, the *credibility* of the policymakers is fundamental, together with their limited discretionary policies, transparent and simple new rules transmitting signals to the marketplace.

Edwards (1992, p. 129) recognises that transition countries in Europe face three main problems: macroeconomic stabilisation, structural reforms, and privatisation. At the outset of a transition process, however, the adjustment of macroeconomic variables appears to be the first challenge with the following open questions: (I) how to iron monetary and fiscal disequilibrium, including the elimination of monetary overhang, (2) what anti-inflationary programme and what nominal anchor(s) to chose, and (3) how to reform the labour market and to what extent to de-indexed it.

In his search for answers, Edwards (1992) analyses the experience of Latin American countries and their stabilisation programmes, looking for some similarities. Relying mainly on Chilean stabilisation exercises, the author draws some important lessons for European transitional countries, highlighting at the same time that there are profound differences between the two regions, although those happen to be mainly political. Thus, the author warns the policymakers in Eastern Europe that none of the programmes of Latin America should be automatically applied.

The characteristic of macroeconomic disequilibrium at the beginning of transition was that it exhibited the *stock* and *flow* component. According to Edwards (1992, p. 134) "the stock disequilibrium, which generated a monetary overhang, has been the result of years of rapid money creation under generalized price controls and declining productivity. [...] The flow disequilibrium, on the other hand, has been the result of large (and increasing) fiscal deficits that have been monetized". All countries with both stock and flow disequilibrium were advised to eliminate the monetary overhang first.

Defining the monetary overhang as an excess of actual real stock of money (M/Py) over the desired stock of money $(M/Py)^*$, Edwards (1992, p. 135) argues that there are four possible ways of monetary overhang reduction. Theoretically, these can be: (i) a reduction in money balances M by monetary reform, (ii) a one-time increase in price level P, (iii) an increase in real output y, and (iv) a rise in the desired stock of money $(M/Py)^*$. The author suggests that the third and fourth options are impractical, whereas the first and second solutions are both feasible, although not equally complex. In particular, a monetary reform requires an accurate estimation of monetary overhang quantum and may undermine the confidence in domestic currency, while a price-level adjustment can induce serious inflationary pressures, as it did in Poland and Yugoslavia.

Fiscal discipline is another building block toward successful stabilisation. Stabilisation requires actions on both sides of the state budget, that is, revenue and expenditure side. On the part of the budget revenues, stabilisation, and transition in general, necessitates the introduction of a new tax system, possibly indexed to inflationary corrections. Similarly, the expenditure side demands a new approach to state finances *via* drastic cuts in budget subsidies to state enterprises. This strategy, however, opens the problem of enterprise debt restructuring, which can be solved either through privatisation or through the transformation of fiscal deficits into quasi-fiscal deficits.

Edwards (1992) argues strongly for an overall de-indexation of the economy since implicit or explicit indexation enables the persistence of a high inflation. The idea behind the de-indexation is to transform economic agents' behaviour by enhancing their economic forward-looking aspects instead of backward-looking methods related to inflation movements. Labour market reform and the de-indexation of wages in this context play an important role as they allow for more flexibility of labour markets. Labour market flexibility, in turn, brings a short-run fall in wages, which in combination with trade liberalisation may reduce unemployment growth rates. If the opposite happens and if wages remain indexed and unable to flexibly adjust to trade liberalisation effects, one may expect the unemployment rate to rise further.

In relation to the nominal anchors of stabilisation programmes, the author looks at the exchange rate based programmes. Edwards (1992, p. 142) argues that such plans, if they are to be successful, must be *credible* and accompanied with the "required corrections in the fundamental determinants of inflation, such as the fiscal deficit and money creation" in order to avoid large real exchange rate overvaluations. Credibility, according to the author, can be achieved through the coherence of the programme and by the imposition of certain institutional constraints, which will ensure the government's commitment to an exchange rate anchor and fiscal discipline.

Edwards (1992) concludes that only a credible stabilisation plan based on tight fiscal policy and coupled with de-indexed labour market can avoid serious overvaluation in the case of exchange rate anchoring strategy not relying on system inertia. This finding is of particular importance for our analysis of Serbian stabilisation programme discussed in Chapter III of this thesis.

Williamson (1991), in his relatively short paper, analyses the convertibility issue as a precondition for integration of transition economies with orld markets and increased competition. According to Williamson (1991, p. 252) "convertibility means the right to change domestic currency into a hard foreign currency [...] convertibility does imply the right to convert at the legal exchange rate, rather at an unofficial or parallel (normally depreciated) rate". There are, however, different concepts of convertibility.

Current-account convertibility assumes the right of an enterprise or a person to freely make payments *and* import whatever necessities, thereby enabling world prices to prevail in the domestic markets. Unrestricted convertibility implies that exchange restrictions on capital exports are abolished and that firms and individuals may export capital at the official exchange rate. Commodity convertibility gives an enterprise the right to solely handle its cash balances, but it must be coupled with the hard budget constraints. In fact, Williamson (1991, p. 253) argues that "hard budget constraints, commodity convertibility and market-determined prices are the three changes that jointly define the move from a planned to a market economy".

Even though convertibility induces certain macroeconomic costs in terms of preventing full employment, the author underlines that benefits stemming from convertibility are greater for transition countries, as convertibility fosters price adjustment and decomposes monopolistic practices by increasing competition. However, convertibility can promote these developments only if coupled with the right mix of trade and exchange rate policy.

In relation to trade arrangements, the author argues for a controlled and gradual opening of weak transition economies towards the world, but suggests a more liberal protection system among transition countries themselves. *Vis-à-vis* exchange rate policy, Williamson (1991, p. 261) believes that a short-term fixed exchange rate peg to the deutsche mark (DEM) makes a right policy option if followed by long-term exchange rate flexibility and substantial devaluation that should secure external competitiveness.

Governments should also ensure that certain macro conditions (control over domestic demand, satisfactory balance of payments position, adequate stock of reserves) are secured before convertibility is introduced, whereas convertibility can go in parallel with microeconomic adjustments such as efficient bankruptcy procedures, etc.

In his highly influential and frequently cited book, Bruno (1993) treats the problem of crises, stabilisation and economic reform in general. However, in relation to stabilisation and reform in Eastern Europe, the author analyses the initial Yugoslav, Polish and other countries' reform efforts of the late 1980s and early 1990s and raises the questions of price shock, output decline, fiscal sustainability, and macroeconomic policy agenda during the transition.

In relation to the initial price shock, Bruno (1993) argues that the difference between expected, i.e. estimated, and actual price levels of transition countries derived from many sources (initial conditions, price response to exchange rate depreciation,[15] large unabsorbed monetary overhang, enterprises monopolistic behaviour, etc.). The author also claims that the relationship between the initial price jump and a consequent inflation profile exhibit certain trade-offs in cases in which there truly existed large monetary overhang, implying once-and-for-all price rise. However, where this was not the case, price hikes had direct effects on the persistence of inflation inertia.

Over the issue of output decline, which occurred during the early years of transition, Bruno (1993) makes a case for a gradual and credible trade liberalisation. He builds his argument on the basis of an expectedly prolonged response from the real economy to changes in the economic system and the fact that regional trade networks were disintegrated once the transition period began. Consequently, the author believes that a government commitment to a pre-announced five-year trade liberalisation plan could have secured lesser output decline in the initial phase of transition.

The author further opens the issue of fiscal balance sustainability during the transition years. Bearing in mind McKinnon's (1991) comment on the increased safety nets expenditures and tax base erosion, the fiscal balance sustainability must be backed by a new VAT system. However, as the new tax system takes years to start giving full results, governments in transition resort to infrastructure investments cut-offs in order to maintained a balanced budget. Since the long-term economic costs of low infrastructure investments are high, Bruno (1993) suggests that the best solution is to plan these investments at least three years in advance and to define them precisely.

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[15] Bruno (1993, p. 222) explains that "in Israel this is called the 'dentist effect' because dentists allegedly raise their fees by the same rate at which the price of their material inputs rises even though these inputs comprise only a small portion of the cost of treatment".

Issues complementary to fiscal sustainability are current account sustainability and nominal anchor viability. Bruno (1993) believes that current account sustainability must be considered within a medium-term period. He underlines that the exchange rate anchor needs to be supported by a public sector wage ceiling as long as large public enterprises exist. However, these measures only represent general rules, whereas the specific choice of policy actions in fiscal, monetary, wage and other economic policies, depend on characteristics of each individual country.

Generally speaking, however, the author recognises that stabilisation *per se* could have not brought much benefit, thereby proposing what is nowadays known as 'Bruno blueprint'. This blueprint includes components of stylised stabilisation and structural reforms encompassing the following set of advised actions:

(a) Heal the real macroeconomic fundamentals first and find the right internal and external balance,
(b) Apply 'heterodox' stabilisation *via* introduction of multiple nominal anchors and achieve rapid synchronised disinflation of all nominal variables,
(c) Opt for currency reform, internal debt rescheduling and other administrative measures needed to support new macro-equilibrium,
(d) Undertake structural reforms in order to remove micro-distortions and to facilitate sustained growth, and
(e) Maintain political reforms and build up a strong democracy (Bruno, 1993, p. 269).

Nevertheless, according to Bruno (1993, p. 206), one must distinguished between the stabilisation of price and exchange rate *levels*, which can happen rather quickly, and *relative* prices, which establish slowly as reaction to the changes in investment, production and ownership patterns. This issue, however, reminds us that after the initial stabilisation phase, the transition calls for further structural adjustments. Within this complex process, new roles for governments are necessary. "A hands-off approach cannot be optimal", as Bruno (1993, p. 246) argues. Governments in transition must work extensively on institution building, establishment of new rules of economic behaviour, and must learn how to explain and share them with the general public.

As we have seen already, Sahay and Végh (1995) developed a simple monetary model for non-market economies in order to reveal the sources of inflationary pressures and to assess the effectiveness of their stabilisation programmes in the period 1990-1993. If we expand on what was said about their model earlier, we can conclude that inflationary pressures in transition are the result of the fact that both the nominal anchors (wages and prices) that existed during socialism ceased to be employed during the transition period, but that they had not been replaced by appropriate monetary anchors.

Regardless of the countries' choice of primary nominal anchor (money *vs.* exchange rate), the authors find that all countries also included another nominal anchor, that is, wages. This, in turn, implies that all transition countries resorted to *multiple* nominal anchors during the stabilisation. It is important to understand, though, that the wage targets during a transition refer to *public sector* wages, which in transition economies appear to be sizable, whereas the wage policies in market economies relate to private wages (having in mind that public sector wages are already put in line with the monetary and fiscal policies in those countries).

Analysing further successes and failures of one nominal anchor over another, i.e. money *versus* exchange rate, the authors found that transition countries making use of exchange rate anchors managed to reduce inflation considerably even at the time of immense fiscal deficits and sluggish structural reforms. However, the adoption of the exchange rate nominal anchor did not seem appropriate for those transition countries that either a) lacked foreign exchange reserves needed to support the exchange rate, or b) were not sure about the 'equilibrium' exchange rate level from which to start out.[16] On the other hand, according to Sahay and Végh (1995, p. 31) money-based programmes appeared to be difficult to implement because of: (a) the unpredictable velocity of money, (b) undeveloped indirect monetary policy instruments, (c) the rapid pace of dollarisation, and (d) interventions in foreign exchange markets.

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[16] Begg (1996) argues that besides the inadequate exchange rate reserves the lack of adequately applied tight fiscal policy appears as another reason for non-adoption of exchange rate as nominal anchor. Begg (1996, p. 14) also finds that the issue of the 'equilibrium' exchange rate is less problematic because nominal targets in stabilising transition economies easily adjusted *ex post*. Moreover, in relation to international reserves, Begg (1996, p. 22) points out that a difference must be made between lack of international reserves which results from initial inadequate stock that can be resolved quickly by assistance of international agencies such as the IMF, and inadequate international reserves caused by inherited market conditions and loose fiscal policy.

Finally, by investigating the effects of stabilisation programmes both in transition and in market economies, Sahay and Végh (1995) concluded the following. Firstly, monetary and/or exchange rate accommodation is more important in sustaining long inflationary processes, even though fiscal deficits creates the inroads for inflation in the first place.[17] Secondly, wage policies play more a important role in transition countries than in developed market economies due to the fact that in the absence of another nominal anchor all other variables tend to adjust to the set levels of nominal wages, aggravating inflation pressures. Thirdly, exchange-rate based programmes prove to be more successful in reducing inflation in both transition and in market economies, compared to the money based programmes. Fourthly, if sound macroeconomic policies are pursued, market-based institutions do not represent a condition *sine qua non* in reducing inflation that emerges after a large-scale macroeconomic liberalisation.

As we have seen so far, the modelling of the stabilisation programmes in transitional economies goes in parallel with several important considerations. The political and social consensus about the direction of reforms appears to underline them all as it reinforces the credibility of the stabilisation programmes as such. Also, it is clear that a successful stabilisation, although necessary, cannot hold on its on merits. On the contrary, each stabilisation programme needs to be coupled with sustainable price and trade liberalisation, labour market de-indexation, fiscal sustainability, structural reforms and institution building.

On a more technical level, however, stabilisation also requires decisions about the selection of nominal anchors, exchange rate regime, monetary policy instruments and monetary strategy in general. We examine those issues more closely in the following section through a presentation of selected papers, thus, building a necessary theoretical basis for our further discussion contained in Chapter IV.

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[17] Numerous authors spell out the importance of fiscal policy as if fiscal policy is too relaxed, no monetary programme can hold for long. See, for example, Begg (1996) and Bruno (1993).

2.3.2. Transition monetary strategy and instruments

Bofinger (1990) was one of the first authors to place the problem of the tasks and strategies of monetary and exchange rate policies of transition countries within the context of their possible future EU membership. He did this while bearing in mind the specific conditions of economies in transformation such as the *lack of credibility* of stabilisation policies and *instabilities* of the real and financial sectors during the years of transition.

The starting point for his analysis is the impact of real sector reforms on the design of appropriate monetary strategy. For example, Bofinger (1990, p. 3) underlines that price liberalisation, including the removal of subsidies and monetary overhang, is *per se* of a temporary nature, but that the conditions of economic restructuring "tend to be translated in a permanent increase of the inflation rate and an ensuing wage-price spiral".

The situation in a transition is additionally complicated by the occurrence of very high welfare costs of inflation such as the hoarding of goods, shortages, the reduction of real money balances, etc. Moreover, the most important of monetary policy problems in a transition is the low credibility of the central banks[18], together with the limitations of domestic monetary policy targets. Those limitations, which derive from a high economic instability, undermine the central bank's ability to properly assess (in the case of monetary targeting with flexible exchange rates) three important determinants: the trend growth rate of potential output, the velocity of money, and the target inflation rate which can be tolerated. With regards to monetary policy targets, the author suggests that – having in mind the underdeveloped domestic financial markets of transition economies and the fact that those countries (except from Poland and the Soviet Union) do not represent an optimum currency area (see Section 2.4, p. 44) – credible nominal exchange rate pegs should have a primacy over the flexible rates as an anchor.

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[18] In relation to this Bofinger (1990, p. 5) writes: "An important reason for the low reputation of central banks in all East European countries is their insufficient control over the asset side of their balance sheet. This can be changed only if large parts of the enterprise sector are privatized – which is identical with a substitution of 'soft budget constraints' by stringent bankruptcy laws – and if the high degree of monopolization is reduced by more liberal foreign trade regulations. [...] Even after substantial privatization and trade liberalization it will be difficult for a East European central bank to establish by itself the reputation of being stability-minded. It cannot be excluded that a central bank has to produce some periods of surprise deflation in order to convince private agents of its anti-inflationary stance."

In relation to the central bank credibility problem, Bofinger (1990) offers three solutions: (i) adoption of a unilateral peg to the ECU (i.e. the euro),[19] (ii) participation in the Exchange Rate Mechanism (ERM) in the form of bilateral peg, and (iii) membership in the European System of Central Banks (ESCB). From an institutional point of view, the first solution is the least complicated, while the third makes the most complex.

A unilateral peg to the euro would require strong symmetry in the structures of the real sides of the economies owing to the two currencies (the domestic one and the euro) and high level of foreign exchange reserve to support the peg. Since these symmetries do not exist in the first years of transition – and since the required ratio of reserves to imports, which needs to be in the range between 36 and 69 per cent (see Bofinger, 1990, p. 10) – is not at a satisfactory level in many transition economies, it is likely that asymmetric shocks and speculative attacks will eventually appear, thus undermining the credibility of the whole stabilisation programme. Moreover, under such an arrangement, the European Central Bank (ECB) is not obliged to offer any credit facilities to countries which chose to peg unilaterally to the euro in the case of currency crises.

ERM participation differs from a unilateral peg to the euro as it assumes the credit facilities provided by the ECB at the time of speculative attacks, but at the same time requires a common decision making in relation to realignments. However, even though these two features increase the credibility of domestic monetary policy, the whole arrangement is seen as dangerous in terms of price stability for the 'old' ERM members.

Finally, according to Bofinger (1990, p. 16), "the EMU solution is superior to all other approaches as it solves the strategy and the credibility problem of monetary policy in Eastern Europe without provoking inflationary risks for the other European countries". This arrangement, however, has certain disadvantages to the participating countries over the other two strategies: prohibition of central bank lending to the government and loss of exchange rate as an instrument of adjustment. Nevertheless, the author believes that ERM participation should be excluded as an option, while full EMU membership is the most beneficial for both the transition countries and the existing EMU members.

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[19] ECU is an acronym for European Currency Unit, which existed from 1979 until it was replaced by the euuro in 1999. It was integral part of the European Monetary System (EMS), alongside with the ERM. ECU represented a currency basket made up of currencies of EMS member countries, which never existed in the form of coins and notes, but was used as a unit of account.

Rostowski (1993) analyses the problem of establishing a stable monetary system in transition through the lenses of a solid banking system and an appropriate monetary rule, under the assumption that the stable monetary system is conditioned by the existence of these two elements. Starting from the following preposition of banking reform sequencing: (i) dissolution of a monobank system into a number of state-owned banks, (ii) market opening for private domestic and foreign banks, and (iii) state-owned banks privatisation, the author also examines the implications of such sequencing on banking prudential regulation.

The main attributes of bank sequencing reform in transition economies are initially high ratios of bank deposits to central bank reserve requirements followed by a gradual reduction to a lower percentage. If decreased rapidly to a Western level of 10-15 per cent from an initial 100 per cent, however, a percentage of deposits' reserve backing might induce monetary and macroeconomic instability, as explicated by Rostowski (1993). The underlying explanation is that during the initial phase of a transition, there exists a lack of banking skills in assessing clients' creditworthiness and project risk, which increases the feasibility of bank failure. This, in turn, reduces the readiness of citizens and businesses to rely on bank services, thereby reducing money supply and money multiplier.[20] Therefore, the author suggests that in the initial phases of the banking reform in a transition, bank regulation ought to become tight and simplified. This regulation should include obligatory reserve above 25 per cent in order to ensure that money multiplier and money supply do not become extremely volatile. Additionally, the regulation should include a high capital adequacy ratio (capital to asset ratio) of 25-30 per cent "so that losses resulting from bad loans are born by the owners of the bank's capital and not by depositors or taxpayers (as happens if the bank is bailed out by the state)" as claimed by Rostowski (1993, p. 8).

Moreover, banks should be privatised, allowing private owners to strengthen control over bank management and efficiency. Another way of ensuring banks' prudent behaviour is to allow foreign banks to enter domestic markets, but then the question arises whether to permit those banks to operate under a relaxed regulatory regime.

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[20] Money multiplier, m, is defined as follows: $m=(1+d)/(d+r)$, where d is the ratio of the cash holdings of the non-bank public and bank deposits, while r is the ratio of banks' holdings of reserves and bank deposits (Lewis and Mizen, 2000, p. 325).

Rostowski (1993) further analyses the case for the establishment of an appropriate monetary rule. The author builds the argument for monetary rule on the grounds that: 1) central banks in transition are not knowledgeable about the conduct of monetary policy in an open economy model, 2) the fact that monetary policy conduct in transition becomes an inseparable part of an overall macroeconomic stability concept, and 3) the fact that formerly centrally planned economies have entered the transition with very high inflation.

The situation of high inflation, according to Rostowski (1993, p. 18), requires "fixing the exchange rate of the domestic currency, at least for a short period of time", thereby increasing the demand for domestic money. The process of accommodation of money supply to changes in money demand puts the authorities before the dilemma of a right speed of this adjustment. In principle, the volume and speed of money supply increase should ensure the credibility of a fixed exchange rate system and should not allow an uncontrolled rise in real interest rates. One way of securing this is to introduce monetary rule, which strictly bases money supply on international reserves.[21] The main question then, however, is how to accumulate international reserves in a way to back the currency fully.

Another solution to the high inflation problem can be a currency board[22], but the author himself argues that 'broad money rule', which we described above is probably more suitable for transition countries than the classical currency board system. This is especially so because the currency board arrangement does not assume the lender-of-last-resort function, as that did a monobank in the centrally planned economies and, thus, may represent a too sudden and big change for a fragile transition banking system.

As a result of all these consideration, Rostowski (1993) suggests that during a transition, the monetary system should firstly be based on a 'broad money rule'. Subsequently, it should switch to a 'high-powered money rule', which postulates that central bank reserve money to banks is determined by international reserves and the balance of payment position of a country. And, finally, only once banking skills are improved should a currency board system be introduced.

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[21] Alternatively, Rostowski (1993, p. 20) proposes different monetary rules, such as 'fractional monetary rule' or a 'marginal monetary rule' as more relaxed in terms of reserve backing, but with the correspondingly lower insurance over the credibility of the system.

[22] See Chapter IV.

Hilbers (1993) examines a particular situation of ex-socialist countries and their usage of monetary policy instruments during the transition times, arguing that the choice of monetary instruments depends on the actual characteristics of financial system of an economy. Consequently, Hilbers (1993) distinguishes four stages of development of financial systems, which are characteristic of former centrally planned economies.

The first stage assumes that the traditional monobank system is formally replaced by a two-tier banking system, but with remaining centralised monetary practices. The second phase is characterised by a price liberalisation, segmented state-owned banking system, increased nominal interest rates, negative average real interest rates, excess reserves, weak interbank markets and underdeveloped markets for government securities and other financial assets. The third stage can be recognised by increased financial liberalisation, bank privatisation and competition, market-determined interest rates, increased liquidity of the system and hard budget constraints. The fourth stage corresponds to the financial system developments prevailing in a market economy.

Further into this essay, the author offers four general definitions of monetary policy instruments.[23] Since these are important for our further analysis, we reproduce the most significant below:

> "[...] Direct instruments act directly on credits granted by banks, while indirect instruments work indirectly by influencing the banks' liquidity and thereby their potential to provide credit [...] Direct instruments set or limit either prices (interest rates) or quantities (credit), while indirect instruments operate by influencing demand and supply conditions". Hilbers (1993, p. 2)

The author states that there exists a general misconception of direct instruments as rigid and administratively regulated and indirect instruments as fully market-oriented, underlining that this view is false and radical. In order to reveal this taboo, he thoroughly describes the different types of direct and indirect instruments. Brief summation brings a reader to the conclusion that the most common direct instruments of monetary policy include interest rates caps and credit ceilings. On the other hand, among the most important indirect instruments are reserve requirement, open market operations and central bank borrowing.

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[23] It should be noted that Lindgren (1991) was the first to propose a general classification of monetary policy instruments and their separation on direct and indirect instruments. For further details see Chapter IV of this work.

The author also elaborates on different conditions which need to be met in order for some instruments to be effectively applied, based on the level of development of the financial system in question. Hilbers (1993, p. 13) finds that the characteristics of financial systems during the initial stages of the transition toward a market economy "support the use of relatively directly controlled quantitative targets". He also concludes that the choice of instruments in such a set up was rather limited and it was not directed at establishing macroeconomic stabilisation, but rather at controlling micro-level financing. Consequently, the author's view is that a policy turn in usage of indirect instruments should happen gradually, in tandem with the reform of the financial sector of transition countries and the formation of reliable institutions of a new market-oriented financial sector. In the meantime, however, transition countries should continue relaying on direct monetary instruments.

Buch (1995) places the issue of transition monetary strategy and instruments into the broader context of banking system transformation offered by Hilbers (1993), starting from a view that these two problems are interrelated and mutually dependent.

The first question the author raises is the choice of intermediate targets between the four main types of intermediate targets: (i) volume of money supply, (ii) prices at which gold or foreign currency are convertible into domestic currency, (iii) interest rate variables such as the nominal market rate or the real interest rate, and (iv) other variables like GDP. However, since all these intermediate targets are difficult to measure during the transition, Buch (1995, p. 5) proposes that the choice of an intermediate target be based on the magnitude of financial and real shocks to which a country is exposed. Having in mind, though, that these shocks occur simultaneously during the transformation process in a magnitude which is hard to predict, the author suggests that the instability of money demand and the controllability of money supply are looked at in more details before a particular intermediate monetary target is actually implemented.

The *instability* of money demand seems to derive from the instability of the income velocity of money in a directly proportionate manner. Noting that "velocity is a function of income, nominal interest rates (i) – which determine the opportunity costs of holding money –, and the expected price level (P^e)", Buch (1995, p. 6) concludes that those variables which influence higher velocity also induce higher opportunity costs of

holding money, thus lowering money demand, and, *vice versa*. Consequently, based on a specific structure of money demand[24], different levels of money supply lead to various degrees of price increases implying that the optimality of specific monetary aggregates as intermediate targets cannot be assessed in advance (Buch, 1995, p. 6). This is even more so because there are two transition-specific factors, which additionally affect the measurement of velocity: (a) non-inclusion of private sector output in GDP statistics, and (b) overestimation of real velocity.

Regarding the *controllability* of money supply, Buch (1995) recognises two main problems relating to a specific monetary aggregate chosen by the central bank. The first problem steams from the fact that some of the factors affecting monetary aggregate are not easily observed by a central bank such as the actual money stock and money multiplier. Additionally, even the level of base money – due to unexpected changes in cash demand – is not always fully under the central bank control.[25] This control problem is particularly important during the years of transformation when the level of excess reserve holdings of banks change as result of the reform of payment system and due to liquidity problems. The second problem relates to a time lag that occurs in the process of central bank observance of the money stock including the liabilities of the banking system. Since these liabilities are not registered in accordance to international accounting standards during the first years of a transition, the central bank does not have data on which it can fully rely when exercising money supply adjustments.

Additionally, there exists one more control problem that is characteristic for transitional economies. Namely, the central banks in transition are usually obliged by political and institutional constraints to directly or indirectly define the money supply (Buch, 1995. p. 10). Directly, the central banks do this through supplying direct credits to loss-making enterprises, whereas they do this indirectly by ensuring refinancing facilities

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[24] Buch (1995) notes that the structure of money demand appears to be particularly complex in transition countries due to the abolition of administrative restrictions and transitional changes in the elasticity of money demand to income or interest rates. The author derives the point from Khan and Sundararajan (1991).

[25] The whole paragraph is based on the concept of money supply given by Buch (1995, p. 8) in the following equation: $M = mm \times H = [(cc + 1) / (cc + \pi + er)] \times H$; $H = C + RR + ER$, where M is the level of total money supply, H is the level of base money, MM is the money multiplier, cc is the ratio of currency c to total deposits in the banking system, and $\pi(er)$ is the ratio of required (excess) reserves (RR and ER) to total deposits.

to insolvent banks that provide credits to loss-making enterprises. The money supply becomes endogenously determined in both ways and is the "larger the greater the share of insolvent banks which is dependent on central bank refinancing" (Buch, 1995, p. 11).

Finally, starting from the four stages of financial system development in transition countries,[26] Buch (1995) distinguished five groups of factors influencing the conduct of monetary policy: (i) inefficiencies in the payment system, (ii) soft budget constraints of banks and enterprises, (iii) substitution of bank credits by supplier credits, (iv) structure of the interbank money market and of the banking system, and (v) institutional deficiencies of financial markets.

The author concludes by analysing the monetary policy instruments that have been used in the Czech Republic, Hungary and Poland and their impact on the operations of banks. It appears, indeed, that each of the three countries experienced the above stated problems and, therefore, switched from monetary targeting to other intermediate targets. Thus, one can extend the conclusion offered by Sahay and Végh (1995) that it is premature to introduce monetary targeting in the stabilisation phase of transition economies to the post-stabilisation period.[27] Clearly, time is needed for the payment system, accounting practices and institutional framework of financial system to be reformed and supportive to a market-oriented monetary strategy and instruments.

Šević and Šević (1998) discuss about open questions of monetary policy in a transitional economy. As first, the authors note that with regards to monetary policy objective(s), the central bank in transition should opt for a singe policy objective and that it could establish other objectives once the advancement of the financial system of a country in transition takes place. In any case, the primary objective of a central bank in transition should be "the preservation of monetary stability" (Šević and Šević, 1998, p. 299). However, the authors notice that in operational terms central banks can better target more practical objectives than price stability, these being money supply, exchange rate,[28] interest rates, or other variables.

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[26] See Hilbers (1991).
[27] See Sahay and Végh (1995).
[28] Apart form exchange rate, Šević and Šević (1998, p. 300) also see prices at which gold is convertible into domestic currency as a possible monetary policy intermediate target. See also Buch (1995, p. 5).

Interestingly, the authors believe that the choice among these intermediate targets is generally a *political* one. Nevertheless, due to economic turbulences that exist in transition countries, the authors suggest that magnitude of these economic and financial shocks and their durability be taken into account when deciding upon monetary objectives. Moreover, Šević and Šević (1998) support the findings that propose synchronous application of several monetary targets and instruments.

In relation to monetary instruments, the authors rely on the definition of monetary instruments provided by Hilbers (1993). Extending those definitions, Šević and Šević (1998) conclude that a central bank has two channels through which it can regulate the monetary situation in a country: (1) a regulatory power, as provided by institutional central bank framework, and (2) by using the fact that a central bank is a major player in the financial markets.[29] Analysing various monetary instruments, the authors find that during a transition, central banks mainly opted for direct monetary instruments, as these are less sophisticated and more easily applied.

In summing up, Šević and Šević (1998) note that, sooner or later, the central bank in transition will need to make a move towards more complex monetary instruments as this action sends a signal of existence of well functioning financial markets in the country. In doing so, nevertheless, a central bank will be expected to regulate, supervise and arbitrate the entire financial system for which purpose it will have to develop further its 'moral suasion' function, i.e. its overall credibility.

We have seen already that the design of monetary strategy and usage of monetary instruments highly depend on the level of development of financial, payment and accounting systems during the years of transition. Nevertheless, the choices made have greatly influenced and determined the overall results of transition countries. Those results are presented in the following pages, giving an overture for comparison with some of the Serbian macroeconomic achievements presented in our Chapter III.

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[29] One can, however, argue that the second channel draws from the first one, which is the "regulatory power (authority given by the law)" as explained by Šević and Šević (1998, p. 300). Namely, the fact that the central bank is the major player in the financial markets derives from its functions regulated by the law. Such consideration should, nevertheless, only be regarded as partially true due to a more operational perspective in conduct of monetary policy of central banks that place them in the centre of a country's financial scene.

2.3.3. Transition results

Fischer, Sahay and Végh (1996) analyse the stabilisation and growth results of the first five years of the transition (1989-1994) and look at the main short-run determinants of inflation and growth. Their conclusions are rooted in results of transition stabilisation programmes based on their relative *stabilisation time*, not on their nominal *chronological time*. Their findings are, nevertheless, detained with methodological problems since the output data used are biased for conceptual and measurement reasons.

It is interesting that out of 26 transition countries[30] only four countries (the Czech Republic, Slovakia, Hungary and Tajikistan) exhibited two-digit annual inflation, while the rest of 22 countries recorded triple-digit annual inflation one year prior to stabilisation, with the maximum inflation rate occurring at the start of transition process due to price and trade liberalisation. Moreover, up to 17 countries registered periods of hyperinflation[31], but apart from Armenia and Georgia (and, we add, Serbia) none of the hyperinflation episodes lasted longer than four months. Significantly, hyperinflation appeared in countries that faced a serious armed conflict.

As for the cumulative output decline in the stated period, differences among transition countries are huge; the range being bounded by the lowest 15.6 percent of output decline in Uzbekistan to the highest 74.6 per cent in Georgia. Even though these data is highly questionable, it is evident that countries affected by wars and trade sanctions like, for example Croatia, recorded largest output declines.

By running two regressions, the authors conclude that macroeconomic stabilisation is a necessary precondition for growth, although the speed by which a country grow directly depends on the level of undertaken structural reforms. Additionally, it appears that tight fiscal policy and a pegged exchange rate in combination explain the approximately 70 per cent of variation in inflation. Finally, the statistically negative and significant relationship between inflation and growth rates of R^2=0.63 confirms that stabilisation leads to growth; the evidence shows that only Bulgaria and Romania experienced growth before inflation was reduced below 50 per cent per annum.

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[30] The authors analysed 26 Eastern European countries, but the sample does not include Serbia.

[31] According to Fischer, Sahay and Végh (1996, p. 9), Cagan (1956) defined hyperinflation as "inflation exceeding 50 per cent in a period of one month or less".

Cottarelli and Doyle (1999) investigate the overall process of reduction in inflation (disinflation) in transition in the period 1993-1997, its causes and consequences. The starting notion is that stabilisation (once it begun) led to the rapid lowering of inflation rate. As a result, by 1997 more than 20 countries in transition managed to bring inflation below the 60 per cent threshold level established by the authors; 16 of them even brought inflation below 15 per cent on annual level. However, after the initial stabilisation, only Croatia and the FYR of Macedonia kept inflation below 10 per cent for several years. In other cases, further disinflation occurred relatively slowly.

The disinflation in transition countries is accompanied by output decline and large current account deficit. Whether these two variables represent the costs of high inflation, as suggested by Fischer, Sahay and Végh (1996), or they result from the structural changes taking place during transition, is a difficult question. Based on Christoffersen and Doyle (1998), the authors conclude that low inflation is conducive to growth, even though the inflation threshold for transition economies of 13 percent only gets lower as structural reforms progress. At the same time, "no clear evidence of a high output cost of disinflation has been found", as noted by Cottarelli and Doyle (1999, p. 7).

On the other hand, there is evidence supporting the view that disinflation in transition contributes to a widening of external accounts; in the period between 1990 and 1997 the external current account deficits relative to GDP increased from close to zero to above 5 per cent in most of the transition countries. But, the linkage between the two cannot be taken for granted as in some cases the recorded high current account deficits reflected the recovery of growth and investments, rather than a loss of competitiveness.

Moderate inflation[32] of a range of 15-60 per cent per annum, which persisted in many transition countries even after stabilisation took place, reflected the authorities' policy options and their deliberate decision to somehow trade-off higher inflation with higher output growth.[33] Knowing, though, that inflation reversals occurred in many countries and that there is no evidence that costs of disinflation in transition economies are significant, the authors suggest further disinflation up to industrial country levels.

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[32] Moderate inflation (defined as annual inflation rate of 15-60 per cent range) is "likely to be driven more by expectations than by fundamentals", as noted by Cottarelli and Doyle (1999, p. 33).

[33] Policy-makers in transition countries believed that: (i) they should remain credible by further relaying on their successful nominal anchors, (ii) they should not risk further drops in output, and (iii) they made sufficient progress on inflation already.

Cottarelli and Doyle (1999) point out that a number of financial policies also played a role in curbing high and moderate inflation, alongside policy credibility. According to the authors, the context of disinflation in transition is generally set up by indexation[34] behaviour, financial fragility, political economy, and relative price adjustments. Evidence show that indexation and financial instability can pose a problem to disinflation attempts, but that disinflation itself may in turn aggravate financial fragility. Similarly, the non-existence of a political consensus over disinflation efforts increases the costs of high inflation, becoming unsustainable. Moreover, the need for relative price adjustments during transition confronts the disinflation process, especially in the early phase.

With regards to fiscal policy, the authors confirm that fiscal imbalances pose a threat to disinflation. Large initial fiscal deficits coming from increased expenditures and falling revenues during early transition additionally fuel inflation. The fact that government deficits in that phase are financed *via* central bank money printing endangers disinflation attempts. Therefore, as noted by Cottarelli and Doyle (1999, pp. 12), "the development of a broader range of financing options for government [i.e. government securities, auth. remark] alongside fiscal consolidation were key elements underlying the subsequent disinflations". Because after 1993 the transition countries experienced limited inflation inertia from earlier high-inflation periods, credible formal pegs become less important. This explains, at least partly, why many transition countries abandoned formal pegs after the initial stabilisation, making a space for exchange rate floats.[35] Another part of the explanation lies in the authorities' concerns over the entry and exit procedures for formal pegs.[36] Nevertheless, the credibility of disinflation programmes was maintained through improved legal central bank independence and IMF support. In contrast, the effects of income policies applied in some countries on disinflation remain rather vague.

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[34] "Backward indexation implies a lagged response of nominal wages to prices. This raises the output cost of disinflation, thereby reducing its credibility" (Cottarelli and Doyle, 1999, p. 9).

[35] "A striking feature of the 1993-97 inflation stabilizations is the limited use of formal exchange rate or monetary targets. [...] The absence of publicly announced monetary targets, other than rules directly implied by the exchange rate regime as in the case of currency boards, reflects structural change and uncertainty" (Cottarelli and Doyle, 1999, p. 20).

[36] "On the entry side, many countries in the post-1993 period began their disinflations with low international reserves, and so may not have been able to operate pegs credibly at sensible exchange rates. The mirror image of this problem, on the exit side, was the risk for a country of entering the exchange rate peg at a substantially undervalued exchange rate" (Cottarelli and Doyle, 1999, p. 23).

Wyplosz (2000) discuses some open macroeconomic questions related to certain 'microeconomic transformation indicators' and the EBRD's correlation matrix. Although for the author it seems to be impossible to answer the question of whether microeconomic or macroeconomic factors are more crucial for a successful transition for methodological reasons, an interesting conclusion emerges:

> "Microeconomic transformation indicators are positively correlated among themselves, especially those concerning enterprise restructuring, financial institution development and market reforms. These three indicators are also correlated with the macroeconomic performance indicators and the growth performance, especially the budget surplus, with a further strong link between inflation over the whole period and market reforms. [...] inflation stabilization is a pre-condition for growth" (Wyplosz, 2000, p. 25).

Furthermore, by making a homage to the ten-year research efforts in the domain of transition economics studies, Wyplosz (2000) sets his analysis of macroeconomic indicators into a vast milieu of the transition debate 'Big Bang *versus* gradualism'. Summarising accumulated general knowledge and various transitional countries' experiences as well as statistical evidence, the author arrives at the following five conclusions.

Firstly, it has paid to *start early and move fast*; a conclusion that favours a radical approach on the basis of countries' track record and the fact that the countries that had started earlier and harder have progressed better.

Secondly, *stabilise first and grow next*; a conclusion that stresses the importance of macroeconomic stabilisation as a pre-requisite for growth, as well as advocating in favour of severing the link between budget deficits and money growth.

Thirdly, embark on *structural reforms*; a conclusion that points out that transition countries that have conducted structural reforms did better than those countries that imposed strict macroeconomic discipline, although they failed to pursue at the same time the more profound systemic reforms.

Fourthly, *the exchange rate regime is irrelevant*; this implies that in the early years of transition some form of monetary targeting is needed, although it is less important what that target is as far as it is adhered to.

Fifthly, there exist certain *irreversibilities*; a conclusion that refers to the causality between the structural policies and macroeconomic stability of the economy.

2.3.4. Concluding remarks

The presented literature review allows a reader to single out the most important monetary policy issues during the transition years. Two main lines of reasoning emerge. The first deals with the specifics of the initial stabilisation phase, whereas the second refers to a more practical issue of selection of the adequate monetary policy strategy and instruments over the medium- and long-term perspective. A common factor to both cases is the credibility of implemented programmes, as noted by Calvo and Frenkel (1991) and Edwards (1992).

Credibility, namely, appears to be fundamental in reducing (eliminating) strong inflationary dynamics, which existed prior to transition. The establishment of monetary or exchange rate rules makes a precondition for the suppressing of inflationary expectations. However, as noted by Sahay and Végh (1995), the exchange rate-based anchoring programmes appeared to be more successful in bringing down inflation than the money-based programs. Besides, wage policies, which are more critical in transition countries then elsewhere, need to be controlled *via* wage anchors.

It is clear, though, that the adoption of nominal anchors and monetary overhang reductions during the stabilisation phase alone could not bring satisfactory results. The whole set of 'backup' measures such as the de-indexation of labour markets (see Calvo and Frenkel, 1991), fiscal sustainability (see Edwards, 1992), current account convertibility (see Williamson, 1991), gradual trade liberalisation (see Bruno, 1993), structural reforms and institution building (see Bruno, 1993) need to be implemented too. However, in achieving these objectives a set of conditions must be fulfilled. Hilbers (1993), for example, points at the financial system's development as one condition that influences the monetary policy and the usage of monetary instruments. Similarly, Buch (1995) distinguishes five groups of factors influencing the conduct of monetary policy.

The conclusion, nevertheless, is that the central bank must eventually make a move towards the usage of more market-oriented, indirect monetary policy instruments (see Šević and Šević, 1998) and that in doing so it has to strengthen the viability of the banking system through the imposition of tight and simplified banking regulation, as suggested by Rostowski (1993).

All these measures led to certain quantified outcomes. Indeed, the evidence shows that – apart from those countries facing the serious prospect of armed conflict – transitional countries managed to reduce inflation during stabilisation to one- or two-digit points. This, however, happened at the cost of output decline (see Fischer, Sahay and Végh, 1996) and large current account deficit (see Cottarelli and Doyle, 1999). Further disinflation (below 13 per cent) proved to be difficult even though there is no clear-cut evidence about the associated high disinflation costs in terms of output and growth, which depended largely on the progress of structural reforms.

As disinflation during stabilisation brought about limited inflation inertia, the credibility of formal exchange rate pegs became less important and so a number of transition countries opted for a more flexible exchange rate regime once the stabilisation phase was over. The selection of exchange rate regime and the overall monetary strategy, nevertheless, called for a systematic approach to those problems, having in mind the European perspective of the SEE transition countries. Thus, a unilateral euroisation (see Bofinger, 1990) or currency boards appeared as relevant options. The following Section 2.5. deals with those issues more closely, building a theoretical foundations for our analysis in Chapter IV.

2.4. Principles of Economic and Monetary Union

Transition, as a process or a period of changing from one state or condition to another, did not taking place during the 1990s only in Eastern Europe. The countries of Western Europe also went through a certain transition process. This other transition process, however, related to the formation of an economic and monetary union between the EU member states.[37] This 'Western transition' was initiated in order to set the stage for the introduction of a single European currency, the euro.[38] The commencement of the euro meant that countries which joined the EMU abolished one important instrument of their economic policies, namely, their national currencies.

On a general level, the act provoked economists to ask why would a country relinquished its national currency and what were the associated costs and benefits of such a decision. As noted by De Grauwe (1997, p. 5), the discussion over these issues is framed by the theory of optimum currency areas (OCAs), especially on its prevailing and more comprehensive alternative approach.[39]

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[37] The Economic and Monetary Union (EMU) formed in Europe has its roots in the European Monetary System (EMS) that came into force on 13 March 1979 with an aim of creating a zone of monetary stability in Europe. The EMS initially had three components: the ecu, the exchange rate mechanism (ERM) and credit mechanism, which we explain in more details in Chapter IV of this work.

[38] Transition towards the euro included three successive stages. The *first stage* assumed the formulation of convergence criteria, i.e. Maastricht criteria, and ended on 31 December 1993. The *second stage* of EMU lasted from 1 January 1994 until 1 January 1999 and included: the establishment of European Monetary Institute (EMI), which was replaced by the European Central Bank (ECB) in 1998; efforts to achieve economic convergence among the EU member states participating in EMU including full liberalisation of capital accounts and abolition of privileged government financing, and defining the technical procedures for selection of EMU member countries including the setting of irreversible bilateral exchange rates among future EMU participants. The *third stage* started on 1 January 1999 with the euro becoming a currency on its own right, fulfilling its unit of account function. The euro coins and notes came into circulation on 1 January 2002 and by 1 July 2002 all the national currencies of EMU participating countries were completely withdrawn and their legal status was abolished. The countries, which formed the so-called euro zone were all the EU-15 member states apart from the United Kingdom and Denmark, which unilaterally opted out from the EMU, and Greece, which did not satisfy the required Maastricht convergence criteria.

[39] The term 'optimum currency area' relates to a currency area of optimum size from the point of view of its members and, thus, may extend beyond the national boundaries. The central question posed by the theory of OCAs is on what basis should units chose one another as partners in a currency area. According to Ishiyama (1975), the pioneering works on OCAs – *the traditional approach* – try to single out a crucial economic characteristic, which supposedly indicates whether an OCA should be formed: Mundell (1961) believes that a high degree of factor mobility and ability of adjustments to asymmetric shocks is the most important criteria, McKinnon (1963) proposes that a high degree of openness be used as a criterion, Kenen (1969) argues that a low degree of product diversification and low susceptibility to asymmetric shocks is what matters, etc. On the other hand, the cost-benefit approach – *the alternative approach* – explicitly measures the costs and benefits of a common currency and advocates for an OCA to be formed in those situation where marginal benefits exceed marginal costs once the last member joins.

More specific questions, however, relate to issues of institutional implications deriving from the reality of EMU on actual and possible EU accession countries, that is, the European transition countries. This institutional implications fall under two categories. The first aspect relates to specific macroeconomic alignments as stipulated in Maastricht criteria, while the second set of institutional implications steam from the legal requirements of EMU, i.e. from the *acquis communautaire*.

2.4.1. Institutional implications of EMU membership

Temprano-Arroyo and Feldman (1999) produced probably the most cited work on institutional implications of EMU membership for the accession countries. Opening their discussion with a description of contractual and economic relations between the EU and CEE countries and selected Mediterranean countries, the authors further offer an institutional primer on E(M)U accession. Starting from the fact that the EU membership presumes legal approximation of the *acquis* in the area of EMU, the authors conclude that legal adjustment is an immediate challenge for all acceding countries.[40]

The EMU membership presupposes the adoption of the Single market *acquis* by the candidate countries, which in particular requires full liberalisation of capital flows *vis-à-vis* EU countries and third countries including foreign direct investments (FDIs) inflows and outflows, real estate-related transactions portfolio and credit flows. The experience of CEE and selected Mediterranean countries shows that, apart form FDI inflows, other categories of capital flows are likely to remain severely restricted up until actual EU membership due to the shaky macroeconomic situations typical for all transition countries.[41]

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[40] According to Temprano-Arroyo and Feldman (1999, p. 754), "unless the EU grants transitory periods, compliance with these obligations must be ensured by candidate countries by the time of accession". However, since the opt-out status had been disregarder for the new EU Member States during the accession negotiations, no transitional periods or special arrangements actually had been permitted, nor had they been requested by any of the countries in question (see European Commission, 2003).

[41] However, one should have in mind that, in general, all accession agreements, which the EU has signed with the transition countries contain provisions ensuring further gradual liberalisation of capital flows among the signatories.

Additionally, the EMU *acquis* derives from the relevant provisions of the Treaty and the Statutes of the ESCB (Article 109 and Article 14 of Protocol 18):

> "This implies, in particular: i) that their central bank governors should be elected for terms of no less then five years and should only be dismissed under circumstances of serious misconduct or inability to perform their duties (Art. 14 of Protocol 18); (ii) that their central banks should not take any instructions from the government (Art. 108 and Art. 7 of Protocol 18); and iii) that they should have as primary objective the maintenance of price stability (Art. 105 and Art. 2 of Protocol 18). In addition, iv) national legislation should prohibit any form of direct credit from the central bank to the government." (Temprano-Arroyo and Feldman, 1999, p. 757)

With regards to government financing of the central bank and other ways of advantaged financing of the government, the *acquis* is quite rigorous. As noted above, any direct central bank financing of government is strictly prohibited and excludes any form of overdraft facilities, advances, and direct purchases of government securities by the central bank, including purchases from public institutions and purchases in the primary market.[42] Also prohibited is any privileged access by public authorities to financial institutions such as through the placement among banks of public debt at below-market rates. Only central bank purchases of government securities from a third party in the case of open market operations or in the case of refinancing of banks against government paper as collateral is an acceptable form of indirect credit to government.

Moreover, the EU membership has implication on its newcomers in that requires their participation in economic policy coordination and surveillance, ESCB membership, broad economic guidelines reporting, excessive deficit financial assistance procedures, application of the EU-wide payments system (TARGET), *et similar*. The prospect of EU membership alone also pressures acceding countries to strengthen their financial markets and support the market-oriented development of their financial sectors. However, according to the European Commission (2003, p. 39), the acquis relating to the above stated elements only have to be complied with from the date of accession. This contrasts the elements relating to prohibition of direct financing of the public sector, privileged access of the public sector to financial institutions, and central bank independence, which all must be implemented prior to the date of the EU accession.

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[42] Temprano-Arroyo and Feldman (1999, p. 761) note that existing legislation allows for overdrafts or short-term advances if these have a form of intraday credits needed for securing smooth operation of the payment system (as prescribed by the Council Regulation EC/3603/93 of 13 December 1993).

Finally, the authors elaborate on the role of the Maastricht criteria. They qualify the Maastricht convergence criteria as useful guidelines in formulating macroeconomic policies of acceding countries prior to accession, but do not consider them as a precondition for a full EU membership. Namely, the full compliance with the Maastricht criteria does not assume an automatic participation in the euro zone (zone formed by the EU member countries embracing the euro), nor it assumes the EU membership in those cases in which a country fulfils the Maastricht criteria before joining the EU. On a contrary, Temprano-Arroyo and Feldman (1999, p. 751) explain that, even though a country meets all the EU accession criteria, it is difficult to imagine that a candidate country will join the EU and the euro zone simultaneously. Nevertheless, the Maastricht criteria remain a valid set of macroeconomic parameters imposed upon all those countries wishing to join the euro zone.[43]

The adoption of the euro also presupposes that a country (voluntarily) participated in the Exchange Rate Mechanism II (ERM II) for at least two years before joining the euro zone.[44] The ERM II requires the oscillations of participating currency to take place within the bands of ±15 per cent defined with reference to the euro acting as the anchor currency. The mechanism, however, includes marginal interventions of the ECB through the existence of a very short-term financing facility (VSTFF) in case of large fluctuations.

All this will require that some countries with pre-announced crawling pegs or floating rates largely modify their exchange rate regimes prior to join the ERM II. On the other hand, certain accession countries with more or less fixed pegs and currency boards could continue with similar arrangements within the ERM II. In preparing for all these tasks, thus, the candidate should consider various policy options in relation to a speed of alignment to the Maastricht criteria, level of flexibility of their exchange rates and pace and sequencing of liberalisation of their capital accounts.

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[43] The authors' analysis of 1997-98 results recorded by the CEE and Mediterranean candidate countries shows that most countries are close to satisfying two fiscal criteria (public debt and government deficit), majority of them face problems with inflation and interest rate criteria, while almost all countries exhibit divergence in real terms and growth due to the lack of comprehensive structural reforms.

[44] The experience of Italy and Finland, which join the euro zone even without two consecutive years of formal participation in ERM II confirms that the rule is not interpreted very strictly and that, theoretically, a country may join the euro zone on the grounds of its currency being stable against the euro within the standard bands for at least two years without having formally been inside ERM II. This, however, does not apply in the case of new EU Member States.

To calm the overheated debate and speculations surrounding options alternate to the fulfilment of the convergence criteria laid down in the Treaty establishing the European Community, the ECB (2003) issued the official policy position of the ECB Governing Council on exchange rate issues relating to the acceding countries. In principle, the ECB's position underlined the following two points: (1) each new Member State will join ERM II at some point in time subsequent to the accession, and (2) when a Member State is found to fulfil the Maastricht criteria it will also adopt the euro. In this, according to ECB (2003) neither unilateral euroisation nor currency boards can be seen as a way to circumventing those stages.

2.4.2. Exchange rate alignments and capital account liberalisation

The issue of choosing an appropriate exchange rate regime and the accompanying question of the right tempo of capital account liberalisation of transition countries on their way to the third stage of EMU has occupied much academic attention. For example, Mundell (1999, p. 425), quite radically, proposes that all transition countries secure their fiscal balances first and that they adopt "currency-board-like arrangements", i.e. exchange rates fixed to the euro. The author builds his argument on the grounds that the nature of the EMU mechanism, which transition countries will be joining eventually, is rather similar to that of a currency board and that such exchange rate design can help those countries achieve an early convergence to the monetary union.

Similarly, Hochreiter (2000, p. 168) concludes that for "a small(er) country currency board may offer least cost adjustment to price stability" under the assumption of ensured government credibility. However, in the context of capital account liberalisation, *internal policy consistency*[45] matters more than the choice of exchange rate regime since several exchange rate regimes are seen as compatible with the full capital account liberalisation. This is so especially because of envisaged EU membership that enhances policy credibility and makes transitional exchange rate regimes less prone to attacks.

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[45] Internal policy consistency assumes "the internal consistency between exchange-rate and macroeconomic policies" as a key to the sustainability of an exchange rate regime (Hochreiter, 2000, p. 160).

Köhler and Wes (1999)[46] look at the institutional implications of *the euro* on the integration process of transition economies in Europe, including the impact of a single currency on trade and financial flows between the euro zone and accession countries.

With respect to the euro's implications on trade relations, the authors argue that there are anticipated positive growth effects within the EU arising from both microeconomic and macroeconomic efficiency gains. As a consequence, demand for imports from transition countries is expected to rise, too. A reduction in transaction costs along with eased market access due to euro-dominated invoicing may further increase trade between the EU and transition countries. Furthermore, the authors see the euro as a factor that will intensify the competitive pressures within the transition countries that will in combination with prospective market integration with the EU and expected increased growth, attract more investments and underpin structural reforms.

Köhler and Wes (1999) believe that in the medium and long run the euro will expand in financial markets. The consequent outcome will be the prevalence of lower real interest rates. This, in turn, may be advantageous for transitional countries since they will be in a position to finance their economic restructuring at lower prices. However, in the short run the effect may be an increase in speculative transactions of some of the currencies of transition countries. The authors also suppose that the variability of the euro's exchange rate *vis-à-vis* the dollar will affect the transition countries, for a great part of their external debt is dollar-denominated. Nevertheless, one can expect that at least the composition of the official reserves of transition countries will change over time in favour of the euro, due to an increase in trade relations with the EU member states.

Regarding the institutional implications of EMU membership, Köhler and Wes (1999, p. 14) advise that acceding countries should not "establish a hard peg with the euro too quickly" until their market-based systems are strengthened.[47] For similar reasons the authors suggest the sequencing of capital account liberalisation, concluding that the real convergence (in terms of per capita income) of transition countries will probably take longer then nominal alignment with Maastricht criteria.

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[46] It is interesting to note that an identical article to that of Köhler and Wes (1999) appeared in Serbian language signed by Radovan Kovačević (see Kovačević, 1999).

[47] On the other hand, Mundell (1999) believes that all transition countries should adopt a currency board – as the most rigid form of fixed exchange rate – before joining the EMU.

Masson (1999) considers three main *transition strategies* for countries with strong aspirations towards E(M)U membership in relation to their exchange rate policy choices: (1) a currency board arrangement (CBA), (2) a band around an adjustable central parity (i.e. ERM II), or (3) a more flexible exchange rate regime, supported by some other form of monetary strategy. In choosing among these three options there are several points to be considered: the susceptibility to asymmetric shocks, the likelihood of a continuing real appreciation, and vulnerability to speculative attacks.

Even though Masson (1999) himself subscribes to the belief that the production structures between the EU and several reformers (Croatia, Estonia, Hungary, Latvia, Lithuania and Slovakia) are similar and thus not inevitably prone to real shocks, the probability of those shocks appearing under the CBA cannot be ruled out. Therefore, the CBA might not necessarily be the best transition strategy towards the EMU. On the other hand, due to the generally transparent nature of CBAs, they are usually not exposed to speculative attack and therefore are more attractive in comparison to adjustable pegs.

Adjustable pegs, on their side, are not easy defendable in the context of sudden capital flows, but are, at the same time, responsive to a trend real appreciation common to all transition economies. Despite the fact that real appreciation of the exchange rate "is not a bad thing itself" (Masson, 1999, p. 15) if justified by a rapid productivity growth[48], it poses a threat to a CBA aiming at exchange rate stability. The inconsistency between exchange rate stability and low inflation may, in turn, pose serious problems to authorities wishing to fulfil all the Maastricht criteria simultaneously.

Thus, a third strategy of a more flexible exchange rate such as a crawling band or managed float in combination with inflation targeting may serve the purpose. Inflation targeting, however, requires several preconditions: central bank independence, political consent over low inflation, and a predictable relationship between monetary instruments and future inflation; none of which have yet been fully met by transitions economies.

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[48] "*Productivity performance* in the tradables sector is a well-known determinant of the long-run equilibrium exchange rate in a relatively low-income country. Gains in labor productivity in the tradables sector give rise to an increase in wages, including the nontradables, as well as an increase in the price level at home compared to the level abroad, reflected in an appreciation of the real (relative price-based) exchange rate. The real appreciation is manifested in an upward pressure on the nominal exchange rate or on the price level or both. This productivity effect or bias–known as the Harrod-Balassa-Samuelson effect–has been observed during the rapid convergence of low-income economies to advanced economies." (Kopits, 1999, p. 13)

Kopits (1999) builds the case for participation in EMU on the theory of optimum currency areas, assuming that the EMU is itself an OCA. The author finds that, over a medium-term perspective, the forerunner acceding countries (now EU members) – that is, the Czech Republic, Estonia, Hungary, Poland and Slovenia – are likely to benefit from EMU participation. The conclusion is rooted in an argument of an endogenous and self-fulfilling nature of trade, productivity factors, income and output movements between the members of an OCA, and consequently between the members of EMU.

As a step toward the preparation for E(M)U membership (or independently of it) the five a for-mentioned countries have, according to Kopits (1999, p. 13), established exchange rate regimes that would support the credibility of their macroeconomic policies. At the same time, all countries subordinated their exchange rate policies to the objectives of price stability and increased external competitiveness. In doing this, these countries have paid particular attention to their productivity performance, wage formation, monetary and fiscal stance, soundness of financial institutions, and exogenous shocks as the main determinants of nominal exchange rate movements. The author considers the relative influence of these determinants on exchange rate movements as a solid indication of the countries' readiness for their future ERM II participation.

The analysis undertaken by the author shows that new ERM II participating countries can become especially vulnerable to economic shocks if they do not increase wage flexibility, fiscal and monetary discipline, and financial sector soundness alongside with operational skills in managing a stable exchange rate regime prior to the ERM II membership. Once these conditions are met, a country should then "approach fixed parity exclusively with the euro [...] and widen substantially the official margins" (Kopits, 1999, p. 34). Final preparation for ERM II should consist of shadowing the euro unilaterally.[49]

This whole convergence exercise, as suggested by the author, should stretch over a five-year horizon. Along this path it is likely that two policy dilemmas concerning the scope of revaluations and implementation of capital controls will appear, but accession countries and the EU members should decide upon them jointly.[50]

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[49] "[D]e facto staying within the exchange rate corridor–as closely as possible, but without adhering to it at all costs, especially since this will not be requirement even with formal participation" (Kopits, 1999, p. 35).
[50] These dilemmas result from accession countries' experience with the possible upward exchange rate pressures due to long-term productivity growth and capital inflows following successful stabilisation.

Bofinger and Wollmershaeuser (2000) start from the point that independently floating exchange rates are not suitable for transition economies gravitating towards the EU. Thus, the authors elaborate on the aspect of monetary policy disinflation *via* exchange rate targeting aiming at amortising destabilising capital inflows. The main characteristic of such an approach is "the policy-maker's ability to exert monetary pressure by two different but interrelated channels: the interest rate channel and the exchange rate channel" (Bofinger and Wollmershaeuser, 2000, p. ii).

The authors put their analysis into a context of a three-stage process of accession to the EMU: (i) Stage I covers period until the full EU membership during which accession countries do not have any institutional exchange rate relationship with the EU (pre-accession stage), (ii) Stage II covers the term from EU accession to two-year period preceding the EMU membership during which acceding countries are expected to adopt the *acquis communautaire* while they can still apply a country-specific exchange rate regime, although they can also participate in ERM II, and (iii) Stage III covers two-year testing period before the EMU accession during which the EU newcomers must comply with the Maastricht criteria and thus cannot resort to any country specific exchange rate arrangements.

Assuming that all accession countries will pursue stable macroeconomic policies during the period of transition towards the EMU, the authors focus on uncovered interest parity (UIP)[51] condition to examine a constraint it imposes on various forms of exchange rate targeting. A conclusion emerges that during Stages I and II a fixed nominal exchange rate target can be a solution only for countries with the inflation differential *vis-à-vis* the anchor currency (the euro) of less then 3 per cent,[52] whereas for all other countries a flexible exchange rate target (with or without an announced targets)[53] should become a policy preference. Stage III requires no devaluations of domestic currency, thus implying that the countries should enter this phase with "a somewhat undervalued currency and adjust downwards if necessary" (Bofinger and Wollmershaeuser, 2000, p. 27).

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[51] "If domestic and foreign securities are substitutes, perfect capital mobility ensures the equalization of expected net yields including the expected rate of increase of the domestic currency price of foreign exchange ('uncovered interest rate parity')" (Lewis and Mizen, 2000, p. 184).

[52] In this, CBAs as a form of fixed nominal exchange rate target is only advisable for very open economies with the ration of openness (1/2 [Exports + Imports] / nominal GDP) higher then 72.5 per cent.

[53] However, "if the exchange rate target is not announced, the nominal anchor has to be provided by a publicly announced inflation target" (Bofinger and Wollmershaeuser, 2000, p. 22).

Nuti (2000) sketches out the main costs and benefits of unilateral euroisation. The term *euroisation* defines the situation in which a country officially decides to adopt the euro as a legal tender without previously obtaining consent by the ECB as the euro issuer. The euroisation can take a form of a currency board or can imply "formal replacement of the national currency" (Nuti, 2000, p. 2) by euros.[54] Even though it is possible to imagine that some other country – apart from those countries in Eastern Europe wishing to join the EU – resorts to euroisation, it is less likely that this will actually happen. Thus, euroisation is generally seen as an arrangement that can (but not necessarily must) precede the EMU membership or can be regarded as an alternative to it.

According to Nuti (2000), the *benefits* of such unilateral euroisation include: an increased ability to borrow on international markets in euros ('domestic' currency), reduced exchange rate volatility and vulnerability to speculative attacks, lowered transaction costs, grater economic and integration with the EU *via* increased trade and investments, declining currency risk premium, "automatic, self-regulating adjustments in money supply" (Nuti, 2000, p. 8), and eased choice of intermediate monetary targets implying lesser costs of exchange rate adjustments for producers and financial institutions.

On the other hand, the *costs* of unilateral euroisation account for the following: the need for excessive international reserves to back the currency in circulation, loss of seignorage, inexistence of a lender of last resort that could increase financial sector fragility, inability of full elimination of a parity change due to higher aggregate demand then in the euro-zone and lesser government credibility than that of the EU, transformation of current account deficit due to "regional under-development" (Nuti, 2000, p. 12), inadequate level of foreign trade invoicing in euros, large part of external debt denominated in dollars, inability to exercise nominal revaluation, and unsuitability of monetary policy pursued by the ECB to the real fundamentals of a national economy. Additionally, indirect costs also include the non-existence of formal support by the ECB such as the provision of lender of last resort, very short-time financing facilities and financial sector supervision of a country which opted for unilateral euroisation.

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[54] "The Currency Board is Euro-isation in a broad sense, while the use of the actual Euro of other EMU-area means of payment are Euro-isation in a strict sense – though both falling short of the full-fledged Euro-isation obtained through full EMU membership" (Nuti, 2000, p. 5).

In conclusion, the author states that the cost and benefit net balance of unilateral euroisation for European transition countries depends on empirical estimates of all the above-stated monetary and other economic considerations.[55] Nevertheless, the possible net advantages of such an arrangement should be considered carefully and in parallel to real convergence of these countries toward its Western partners. In any case, increased mutual trade and economic integration should stay first on the reformers' agendas.

2.4.3. Concluding remarks

The purpose of this section was to single out the main institutional requirements of EMU membership and its underlining policy considerations. By analysing Temprano-Arroyo and Feldman's (1999) paper, we have seen that in general these institutional issues can be resolved by adopting the EU *acquis*, but what specific challenges these legal adjustments may pose to an EU acceding country, and to Serbia in particular, is the main question of the Section 2.5 of this chapter and our entire Chapter V.

Nonetheless, a number of important macroeconomic policy issues deriving from the EMU institutional framework and from the Maastricht criteria need to be considered by those countries aspiring to EU membership well before this membership takes place. However, the nominal compliance to formal criteria should only steam from a real convergence and not the way around, as suggested by Köhler and Wes (1999). Gradual fiscal adjustment, steady opening of capital accounts, rapid disinflation and increased exchange rate flexibility are some of the general rules of this exercise. But, in practice, each country should decide on its own policy mix due to different country-specific factors like the flexibility of wages, soundness of financial sector and other (see Kopits, 1999). We apply this approach in the case of Serbia in Chapter IV.

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[55] Similarly, Kopits (1999, p. 5) notes: "In general, the net benefits from joining an optimal currency area [assuming that the EMU is an OCA, auth. remark] will be larger (a) the smaller the size of the candidate country relative to the union, (b) the higher the degree of economic and political integration between the candidate and the union, (c) the stronger the similarity in economic structure between the candidate country and the union, and (d) the larger the public indebtedness of the candidate country. Characteristics (a), (b) and (c) reduce the likelihood of asymmetric shocks in the enlarged union that need to be offset through policy action at the country level. Further, a major up-front gain, in the form of a significant reduction in exchange rate risk premium, accrues under (d) [...]".

2.5. Central Banking in Transition

In Section 2.2 of this chapter the central plan dominated the real side of previously centrally planned economies. Similarly, a central credit allocation governed the monetary and financial developments of countries with such an economic setting, having had the state bank at its centre. The state bank–*the monobank*–in socialism performed the functions of both the central bank and the commercial banks, holding a 'monopoly' over banking and credit.[56] However, the monopoly was not effective as the bank could not autonomously decide on whom to grant credit, but was rather obliged to suffice the credit in accordance to the central plan.

As a consequence, monetary instruments did not have an active role in the distribution of financial sources. Monetary policy was exercised exclusively through the control of the overall volume of credit to state enterprises and budget entities. Interest rates and exchange rates also did not play a role in credit allocation. Therefore, once the transition started, it needed to encompass not only the process of transformation of a central bank in the cases in which it existed prior to transition or of building up a monetary authority where it did not exist, but also the reform of societal perception and the role which central banks have had in the management of socialist economies.

Perception and the role, but also, in a way, the policy outcomes of a central bank, derive from the institutional framework in which the central bank operates (Cukierman, 1992, p. 5). Therefore, reforming the central bank legislative site makes an important step towards the overall central bank reform.[57] The construction of an appropriate legal framework requires a number of considerations to be taken into account, especially those relating to the redistribution of political power such as central bank independence, accountability, transparency and credibility, which are seen as necessary in securing monetary and financial sector stability and effectiveness.

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[56] The situation was not entirely the same in all socialist countries. As noted by Sundararajan (1991, p. 250), "the pre-reform banking system in Yugoslavia consisted of a large number of banks owned 'socially', that is, associations of workers in nonfinancial enterprises joined together to form each bank. In effect, banks were 'owned' by enterprises. The state bank–the National Bank of Yugoslavia, and the national banks of the regions–was a major partner in extending credit to enterprises in selected sectors in the form of cofinancing (so-called refinancing) with individual commercial banks." See also Šević (1999, p. 204).

[57] The central bank reform assumes introduction of a new: monetary and exchange rate management, monetary instruments, banking/insurance prudential regulations, payment system and research techniques.

In the context of transitional economies, the appropriate central bank legal framework is broadly defined as the one which enforces economic decision-making that is based on market principles (Lybek, 1999, p. 76). At the core of market practices and central bank legal arrangements stands a clearly defined central bank's objective(s)[58], against which the performance and behaviour of the central bank, i.e. the central bank governing bodies', can be measured. Theoretically, however, such institutional solutions derive from the theory of time inconsistency (dynamic inconsistency), analytically presented by Kydland and Prescott (1977) and Barro and Gordon (1983).

According to Barro and Gordon (1983, p. 599), "the term 'time-inconsistency' refers to the policymaker's incentives to deviate from the rule when private agents expect it to be followed". Namely, due to the existence of inflationary bias, deriving from various policymakers' motives[59], the monetary authority (usually the central bank), which operates in a discretionary regime, is tempted to create surprise inflation above private agents' inflation expectations. The results appear to be excessive rates of monetary growth and inflation, and activist countercyclical central bank behaviour with no desirable effects in terms of unemployment. On the other hand, as pointed by the authors, under institutional arrangements in which monetary authority is expected to precommit its future policy choices to appropriate policy rules, the outcomes improve. In fact, under such a setup, the central bank policy becomes credible – that is, dynamically consistent.

The above model has become the basis for numerous other scholars to build new analytical or conceptual frameworks for the resolution of the inflationary bias problem of dynamic inconsistency in monetary policymaking. In particular, their attempts have focused on institutional design of central bank behaviour. With respect to that, Rogoff (1985) and Walsh (1995) provided the two main theoretical strands for central bank independence, thereby opening a debate over two other central bank institutional attributes: a central bank's accountability and transparency in its conduct of monetary policy. At the heart of these discussions, however, remains the central bank's credibility, as the ultimate objective of any public policy and, *inter alia*, of monetary policy.

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[58] Regarding the monetary policy objective(s) of central banks in transition, see Šević and Šević (1998).
[59] Cukierman (1992, pp. 15-25) singles out (i) reduction of unemployment, (ii) increase of fiscal revenues, (iii) smoothing of interest rates, and (iv) avoidance of excessive balance of payments deficits under fixed exchange rates, as the main four policymakers' motives for monetary expansion under perfect information.

2.5.1. Central bank independence

Rogoff (1985) builds the *theory of a conservative central banker* on a presumption of the existence of dynamic inconsistency due to which a society constantly faces a higher then optimal inflation. He develops an institutional response to this problem through the appointment of a conservative central banker who is more inflation averse then the society. In this model, the central bank's independence is necessary because the central bank must ensure that its preferences, and not that of the society, determine the monetary policy. However, Rogoff (1985) also underlines that in such a setting the output variability increases as a cost of lower and more stable inflation rate than it would be under the less conservative and less independent central bank.

Walsh (1995) offers an alternative *principle-agent approach* for solving the inflationary-bias problem of discretionary policy.[60] The model assumes a contract between the society (principal) and the central bank (agent) over the inflation output embodying penalties for a central bank when realised inflation deviates from its target level. The principle-agent approach differs from the conservative-central-banker approach in that it does not secure both the central bank *goal* and *instrument* independence, but just its independence in the selection of monetary instruments. On the other hand, in the Rogoff (1985) approach, the central banker – who is expected to maximise its own utility function – is actually given both goal and instrument independence. The principle-agent approach differs from the conservative banker approach also because it assumes less output variability due to the fact that it allows for an optimally active counter-cyclical central bank policy to be carried out.

McCallum (1995) highlights to two 'fallacies' relating to interpretations of the above-mentioned analytical results. The first points to the fact that central banks need not always to exploit the existing inflationary expectations, even they are tempted to do so. The second criticism recognises that the principal-agent contract does not overcome the motivation for dynamic inconsistency, but that it merely relocates it by increasing intricacy for the governments to pressurise central banks (McCallum, 1995, p. 210).

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[60] See also Persson and Tabellini (1993)

According to Cukierman (1992, p. 9), "central bank independence can be viewed as one way of committing monetary policy to focus mainly on the objective of price stability. Various degrees of independence lead to various levels of commitment." To test the central banks' legal and factual independence and political instability, the author opts for alternative measures[61] from a broad sample of around 70 countries. Using this data in evaluating the effects of independence and of the political situation on policy outcomes, i.e. inflation, he concludes that in developed countries – in accordance to the common belief – a higher legal independence of a central bank, indeed, corresponds to higher price stability and is an important factor for inflation determination. However, the author also finds that in the less developed countries, price stability depends more on the rate of turnover of the central bank governors than on the central bank legal independence.

Additionally, by combining the various used measures of central bank independence, Cukierman (1992) produces a singe inflation-based ranking list of central banks for both groups of countries (developed and less developed), based on their overall independence. The rankings show varying degrees of central bank independence among countries as a result of underlying different country-specific structural and other factors.

Indicatively, the structural determinants show that in countries with a higher level of national consensus, more political instability induces higher central bank independence and that the opposite stands true for countries with a lower degree of internal coherence. Moreover, the author uncovers that persistent past inflation tends to erode the independence even though the legal independence remains the same. This implies that an independent central bank alone cannot restore disinflationary processes, but that it needs support by other institutions. "It seems therefore that CB [central bank, auth. remark] independence is more effective as a preventive then as a remedial device", Cukierman (1992, p. 449) concludes.

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[61] According to Cukierman (1992, p. 5), "these measures draw on three types of sources. One is based on the legal independence of the central bank, the second on the turnover rate of central bank governors, and the third on responses by central bankers to a questionnaire on central bank independence". Potentially, however, the following factors may also influence the degree of independence of a central bank: the quality and reputation of the central bank research department measured by the quality of its publications, the size and the level of development of the countries financial markets and of the overall financial sector, the governor's role as the economic adviser to the government and his reputation, appointment procedures of the central bank board members, ability of the central bank to maintain a sufficiently large volume of open market operations when needed and, in countries with fixed exchange rates, the width of the fluctuation band (see Cukierman, 1992, pp. 393-395).

Goodhart (1993)[62] argues that the idea of central bank independence derives from two sources. The first builds on a widely acknowledged conception that in the *long term* the Phillips curve is vertical, that is, that there is no trade-off between inflation and unemployment in the medium- or long-run.[63] The second argument hinges on the time-inconsistency theory, and implies that politicians are only interested in the *short-run* effects of economic policy due to their concentration on election cycles and on preoccupations associated with the demands of democratic accountability (re-election).

As a result, governments which are keen to subordinate the objective of price stability and lower inflation to the objective of increased employment during the pre-election periods, undermine the possibility of achieving price stability in the longer term. Accordingly, this entails that politicians delegate their authority over counter-inflationary policy to separate, autonomous institutions, i.e. to central banks that have the technical expertise and long-term horizon to achieve the set objective(s).

The assignation of independence to the central bank, nevertheless, has several economic and political implications. The *economic consideration* stands in favour of the argument that the granted central bank autonomy should not mean that all short-term shocks that occur in an economy should be disregarded along with all short-term economic developments. However, Goodhart (1993) argues that it is the level of the central bank credibility that would determine the accommodating capacity of the monetary policy to the short-term shocks at the end, in the sense that a more credible and independent central bank with the longer record of low inflation has a higher capacity to act as a shock absorber in the short period. On the other hand, the author believes that a central bank's credibility can only be obtained if there exists a wide political consensus supporting a long-term counter-inflationary monetary policy and the general public's understanding of monetary policy issues.

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[62] The same article appears in Goodhart (1995, pp. 60-71), under Chapter IV.

[63] "Bill Phillips, a New Zealand economist working at LSE [London School of Economics, auth. remark], had earlier discovered in the 1950s that, using historical British data, when unemployment was high, the pressure of demand in an economy being low, then wage and price inflation had also been lower [...] Milton Friedman then explained that the problem was that the short run Phillips curve had depended on the existing state of inflationary expectations [...] In short, if the authorities tried to keep the level of unemployment below the natural rate, which is, broadly, the rate that causes workers to seek that rate of real wage increase that their own productivity increases make available, then inflation will not be constant, but will rise without limit; in economists' jargon, in the longer term the Phillips curve is vertical" (Goodhart, 1993, p. 2).

The first *political qualification* underlining central bank independence relates to the fact that the central bank is usually not independent in selecting its objective(s), but only the means of achieving it. The second consideration conveys the fact that the establishment of a central bank's legal independence lies in the hands of the legislator and that, therefore, this independence is subject to politicians' preferences at given times. This finding illustrates Goodhart's (1993, p. 9) point that by granting autonomy to the central banks, central banks will not be placed outside of the political context, but on the contrary, that they would need to resort to the "political and presentational skills" more often in order to became more accountable. In conclusion, however, the author stresses that the governments' and central bankers' priorities do not differ greatly and that, thus, the importance of central bank independence should not be exaggerated.[64]

Alesina and Summers (1993) come to an interesting and frequently cited conclusion that central bank *legal* independence is neither negatively nor positively correlated to the macroeconomic performance of developed countries. In particular, by plotting the measures of economic performance (economic growth, growth of GNP per capita, unemployment and real interest rate) of several selected countries for each variable separately against the indices of central bank independence, the authors find no relationship whatsoever between them. The only expected exemption represents "a near perfect" negative correlation between the central bank legal independence and the corresponding countries' inflation records.

With respect to transitional countries, Cukierman (1994) provides only tentative explanations of these countries' levels of actual central bank independence by asserting that these levels are not likely to increase over time due to the following reasons. Firstly, undeveloped capital markets continue to make pressure on central bank lending to transitional governments. Secondly, it is likely that the central banks will continue acting as commercial banks due to financial arrears and narrow capital markets until banking sectors are reformed. Thirdly, even if established quickly, the central bank legal independence should take time to be transposed into actual independence as the respect for the rule of law in these countries strengthens further.

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[64] Primarily, Goodhart (1993, p. 13) believes, the adoption of central bank independence should serve as means of "improved policy measures, in both the monetary and fiscal areas, aimed at longer time horizon, and to a better public understanding of policy issues".

2.5.2. Central bank accountability

De Haan, Amtenbrink and Eijffinger (1998) analyse the three features of central bank accountability: (i) ultimate objectives of monetary policy, (ii) transparency of monetary policy, and (iii) final responsibility for monetary policy. They propose that the decisions about monetary policy objectives rest in the hands of elected politicians (governments) and that the central banks are only granted with instrument independence. Regarding transparency, the authors believe that a central bank should be legally obligated to publish the meetings minutes together with more regular reports on its past performance and future plans, against which its accountability can be measured. They also argue that the final responsibility for monetary policy depends on the central bank relationship with the parliament, the existence of government/parliament's overriding mechanisms *vis-à-vis* the central bank, and the dismissal procedures for the governor.

Based on the current central bank laws and their proposed concept of central bank accountability, De Haan *et al.* (1998) construct an accountability indicator for 16 central banks, including the European Central Bank (ECB). The indicators show a varying degree of central bank accountability in observed countries, with the ECB indicator suggesting a rather low level of ECB's democratic accountability. Additionally, the authors test the relationship between the various aspects of accountability (objectives, transparency, responsibility) and the central bank independence. They find a positive relationship between the selection of a central bank objectives and independence, but negative relationships between the central bank independence and transparency and responsibility, respectively. The authors, however, conclude that the concepts of central bank accountability and independence are not adversarial and that a central bank can be both independent and accountable.

A theory of central bank accountability developed by Eijffinger, Hoeberichts and Schaling (1998) shows that accountability through transparency leads to lower inflation expectations and less stabilisation in the case of productivity shocks. On the other hand, the authors demonstrate that accountability through the shift of final responsibility from central banks to governments induces more inflation expectations and more stabilisation with regards to supply shocks.

Castellani (2002) develops a model of central bank accountability describing a mechanism by which the government holds an institution with a delegated authority over monetary policy, i.e. the central bank, accountable for its policies. The model underscores the *ex post* character of accountability, thereby allowing for a distinction to be made between the notions of accountability and transparency. Namely, in contrast to accountability, which is seen as an ex post political scrutiny of the undertaken central bank's deeds, the central bank transparency is presented as a set of *ex ante* decisions about the central bank's communication and presentation actions.[65]

Another result deriving from this model is that the central bank can be held both independent and accountable in achieving a socially optimal policy if there is no central bank preference uncertainty (zero 'democratic deficit')[66]. However, it also appears from the model that if too much stringency in terms of the accountability mechanism is put in place by the government, the central bank may become overcautious in conducting the monetary policy even when unnecessary. Nevertheless, the author finds that the 'optimal' stringency of the accountability requirements depends on the government's preferences and, presumably, the state of the economy.

It is interesting to mention the work by Padoa-Schioppa (2000) who puts an emphasis on the following institutional attributes of the Eurosystem[67]: independence, accountability, transparency, predictability and communication. In relation to accountability, the author underscores the fact that "accountability is counterweight of independence", where the latter places a limit to the functions performed by the institution(s) to which a central bank is accountable (Padoa-Schioppa, 2000, p. 29).

Thus, the author raises two fundamental questions: (1) for what should the central bank be held accountable, and (2) to whom should the central bank be accountable? Clearly, in the case of the Eurosystem, it is the European Parliament, as a highest democratically elected body of the European Union that should judge the fulfilment of the Eurosystem's legally entrusted mandate. Analogously, at the national level, the author suggests, the central banks should be accountable to their national parliaments.

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[65] The same argument was put forward by Padoa-Schioppa (2000, p. 29) a few years earlier, although in a rather non-analytical, indicative manner.

[66] According to Briault *et al.* (1996, p. 12) an empowered, but unaccountable, central bank may also give rise to a democratic deficit.

[67] Eurosystem comprises of the ECB and the national central banks of the countries that adopted the euro.

2.5.3. Central bank transparency

Geraats (2002) offers a useful overview of the existing literature on central bank transparency up to 2002. Defining transparency as the absence of asymmetric information and building on Geraats (2000), the author distinguishes between political, economic, procedural, policy and operational transparency in accordance with the respective stages of the policy-making process.[68] The author also builds a case for the *economic* argument of central bank transparency, as opposed to the *public policy* argument that treats central bank transparency in connection with the central bank accountability, as explained by De Haan *at al.* (1998).

In order to further develop the economic argument for transparency, Geraats (2002) chooses to single out two effects of asymmetric information: (1) the 'uncertainty effect', and (2) the 'incentive effect'. The first one derives from the fact that in a non-transparent environment with high uncertainty over the monetary policy, the central bankers who possess private information can, in fact, decide to exploit it. The second effect appears in those situations in which the (monetary) policymakers who do have private information try to use it in order to induce certain reactions from those economic agents who do not have that information, but eventually find themselves in a position of aligning their initial policy with the induced behaviour of other agents.

In relation to the empirical evidence on the effects of central bank transparency, Greaats (2002) reminds that there are, in general, four 'measurement' concepts. The first approach measures transparency (qualitatively and quantitatively) through analyses of the exposition and availability of monetary policy information. The second approach relates to measuring the effects of a central bank's concealed information on monetary policy, whereas the third set of transparency measures deals with the market's reactions to disclosed information. The fourth approach investigates the macroeconomic consequences of central bank transparency. Taking into account a number of existing indices of central bank transparency, the author concludes that "transparency tends to be beneficial" (Geraats, 2002, p. 27). Thus, there appear volumes such as the IMF's (1999) "Code of Good Practice on Transparency in Monetary and Financial Policies".

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[68] See Geraats (2002, pp. 8-22) for a detailed explanation of each transparency type.

However, the evidence is not unequivocal and so scholars have still not reached a consensus on the economic desirability of transparency in monetary policy matters. It is thus not striking that a majority of scholars writing about the central bank behaviour are actually tempted to detect and evaluate the effects of central bank transparency (see, for example, Demertzis and Hallet, 2003a; 2003b), or optimal degrees of transparency in monetary policy making (see, for example, Svensson and Faust, 1999; Jensen, 2001), and to engage in investigations on how to achieve transparency (see, for example, IMF, 1999). It is interesting to note that only rarely do the theoreticians and practitioners actually get involved into discussions about the generic notion of transparency and the related (mis)conceptions generated by relevant agents due to information ambiguity.

Among few authors engaging in that exercise is Winkler (2000) who points to different meanings of transparency in the conduct of monetary policy. Although not highly influential, his work is of particular importance as it draws attention to the issue of quality of unveiled central bank information. To be precise, the author provides an insight into various meanings of central bank transparency and proposes a new conceptual framework, which builds on the following four aspects of transparency: (i) openness, (ii) clarity, (iii) common understanding, and (iv) honesty.

Similarly, Posen (2002) presents six 'practical views' of central bank transparency discerning among specific sets of information releases, which can be: (1) reassuring, (2) detailed, (3) irrelevant,[69] (4) contingent, (5) annoying, and (6) diverting. In particular, Posen (2002, p. 5) claims that "the public could be *reassured* in general if updates *via* regular releases about policy decisions reduce worry about what is going on in the short-term". However, we argue that in the case of the disclosure of 'irrelevant' information by the central bank, the opposite may occur. Namely, the public may become more worried about the central bank actions and, thus, about the short-term policy outcomes (real variables) if confronted with the 'irrelevant' information because what may seem 'irrelevant' information could induce alterations in the central bank policy preferences.

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[69] Posen (2002) sees irrelevance of information disclosed by the central banks through the lenses of that information ineffectiveness on changes in inflation expectations. In the words of Posen (2000, p. 5), "the public could find that, after all, what central banks say is *irrelevant*, so long as the central banks are no less responsive to shocks then before".

Arguing that only the reassurance and details-oriented views have been supported empirically,[70] Posen (2002) proposes that the focus be shifted from a discussion over the central banks' target achievements to a communication about the nature of shocks facing the economy. Furthermore, based on conclusions that increased transparency does not inhibit central bank independence nor that it provides for satisfactory democratic accountability, the author suggests that greater transparency and the appropriate formal accountability mechanisms be jointly arranged. Finally, Posen (2002) puts forward an initiative to deduct the goal independence from the central banks' jurisdiction, leaving them with the instrument independence only, underlying that instrument independence together with transparency brings benefits, at least to the inflation targeting countries.

2.5.4. Central bank credibility

By examining the central bank's decision-making, the policy effects on inflation, and the feedback of inflationary expectations to policy choices, Cukierman (1992) has contributed greatly to the theory of new political economy in the area of monetary policy. It should be noted, though, that most of his work draws and utilises from the literature on dynamic inconsistency pioneered by Barro and Gordon (1983).

In his voluminous and frequently quoted work on central bank strategy, credibility and independence, Cukierman (1992) in particular analyses factors behind the positive inflation and monetary expansion rates. As mentioned earlier, the author puts forward four different motives that cause central banks to inflate: higher employment, greater budgetary revenues, stability of the financial system, and attainment of balance of payments objective. Analysing these four motives, he demonstrates that the money supply and, therefore, inflation are not exogenous, but that they are instead influenced by interactions between monetary policymakers and the private sector, those being either institutions or private individuals. In relation to that Cukierman (1992, p. 1) writes:

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[70] Posen (2002) points that in the case of inflation targeting, central bank announcements of medium-term targets increases central bank flexibility with regards to shocks and decrease inflation perseverance.

> "Factors such as the ability to precommit policy, the rate of time preference of policymakers, the precision of their control over the price level, and the degree of political instability as reflected in frequent changes in emphasis on alternative objectives are identified as some of the fundamental determinants of the distributions of inflation and of monetary growth."

Those factors can operate either in the presence of *perfect (symmetric)* information or *private (asymmetric)* information. Cukierman (1992) analyses both cases. Under private information he assumes an information advantage on the side of policymakers deriving from their insight into the changing degrees of central bank independence or political pressures. The fact that those changing circumstances are usually not known by the general public in real time allows the central banks to create inflation surprises (by shifting its emphasis on alternative policy objectives), thereby generating temporary real effects on the economy.[71] Although the author argues that the public learns about the changes in central bank preferences gradually, with every subsequent period of time some new factors become relevant which do not allow for the full elimination of public uncertainty about the course of monetary policy.

Therefore, the author underlines that the existence of asymmetric information becomes essential for a realistic analysis of changes in the credibility of monetary policymakers. Under the asymmetric information only dynamically consistent monetary strategies are credible. However, since private agents are not fully informed about the central bank objectives, there exists a discrepancy between the planned rate of monetary expansion and public perceptions about this rate. In such a situation the credibility becomes "a continuous measure that is inversely related to the absolute value of the divergence between the central bank's plans and public beliefs about those plans" (Cukierman, 1992, p. 207).

In the presence of perfect information, when the public is aware of central bank preferences and limitations, the central bank credibility in the conduct of monetary policy, that is, the policy announcement, is "fully credible if it is dynamically consistent and not credible at all if it is not dynamically consistent" Cukierman (1992, p. 205).[72]

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[71] Those effects come from the short-run Phillips curve and the existence of the underlining trade-off between inflation and employment or output in the short-run, as presented on page 60 of this work.

[72] Fischer (1995, p. 33) rightly notes that the more general informal definition of central bank credibility should extend to those policy announcements and decisions, which were not anticipated at the time the public was making its decisions or acting upon them.

Based on those main postulates, Cukierman (1992) further conducts detailed investigations over the fundamental determinants of credibility under (a)symmetric information and identifies factors influencing output and employment costs of disinflation. Furthermore, he reveals the complexity of central bank's operations depending on whether those are performed under a discretionary regime or under commitment.

The conclusion which emerges is that inflation is excessive under discretion and perfect information. However, Cukierman (1992) finds that in the presence of asymmetric information and discretionary setting, a central bank's temptation to inflate attenuates. This happens in the face of recognition that private agents form their inflationary *expectations* on the basis of current inflation and monetary growth rates. Consequently, Cukierman (1992) notes that a central bank's "reputational considerations moderate the inflationary bias of policy in discretionary regimes". Being aware of a constant, gradual learning process of the general public about its shifting objectives, monetary policymakers become sensitive to their *reputation* as an inflation fighter.[73]

Blinder (1999) stresses that the evolution of the theory of (rational) inflationary expectations contributed greatly to the heightening interest in the credibility of monetary policy announcements of both, academics and central bankers. However, by making use of a questionnaire, the author discovered that the two groups prize credibility for different reasons. Namely, the central bankers find credibility important as it helps them to reduce the costs of disinflation, to keep inflation low, to defend the currency and generate public support for increased central bank independence. Yet although academics agree with the first two reasons, they markedly disagree with the two remaining ones.

On the other hand, when it comes to the methods of creating or enhancing credibility, Blinder (1999) finds that the two parties agree that the establishment of a low inflation record and central bank independence are the most important factors. Surprisingly, though, both the central bankers and academics rank the Barro and Gordon (1983) model of precommitment and incentive compatible contracts as least important.

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[73] Cukierman (1992, p. 205) underlines that the notion of reputation is inherently linked to the existence of asymmetric information.

2.5.5. Concluding remarks

The central bank *in* transition is a broad concept that encompasses the following two developments. The first relates to the fact that the central bank has a role in the overall administration of economic transformation, whereas the second recognises that the central bank itself is constantly in the process of transition. While the third section of this chapter dealt mainly with the central bank's various roles during transition times, the objective of the previous section was to underline the main institutional characteristics of a central bank, including those that operate in transitional countries: independence, accountability, transparency and credibility. Based on a number of studies dealing both with the theoretical and empirical aspects of those central bank attributes, we draw several conclusions.

A central bank should be assigned the adequate level of *autonomy* in implementing monetary policy and should, therefore, be independent from the government. Nonetheless, the concept of the delegation of authority over monetary policy to the central bank should not be confused with a central bank's *accountability*. The central bank must be accountable for its results, but only up to the point in which these results occur as the outcome of its performance and not because of factors that are beyond its decision-making power and jurisdiction. Hence, for the general public and politicians to be able to judge the actions and results of the central bank, the central bank's legislation must include transparency provisions. Once the central bank *transparency* and the related disclosure of monetary policy information are secured – together with the clear central bank objectives and legal independence – it can be expected that the central bank is perceived as *credible* in monetary policy conduct.

It can also be concluded that all these central bank attributes are highly interdependent and can change dynamically over time. They are also highly relevant for the formulation and implementation of an overall monetary strategy and its results. The issue of how this connection is established in practice, however, is discussed in more details in Chapter IV and Chapter V of this work. It is without any doubt that the Serbian central banking experience of the 1993-2003 period provides enough material for such research to be conducted.

2.6. Conclusion

The main purpose of this chapter was to set up a theoretical framework for our further analysis by establishing a benchmark against which the Serbian transitional record of the 1989-2004 period could be measured. In practical terms this benchmark includes the general reform strategy components and monetary policy elements attributable to the CEE and SEE transitional countries. Those two building blocks are respectively elaborated in Section 2.2 and Section 2.3 of this chapter on the basis of an extensive literature review. The results and conclusions obtained in those two sections shall be confronted to those of Chapter III dealing with the Serbian economic legacy up to 2004. In this way, by joining the *theory* (Chapter II) and *evidence* (Chapter III), we provide a new and unique insight into the Serbia's 15-year transitional experience.

However, apart from assessing its past performance, this chapter aimed at depicting the most important theoretical considerations about future European Union membership of the Eastern European transition countries and the accompanying monetary and central banking requirements. Therefore, Section 2.4 and Section 2.5 of this chapter investigate a number of papers dealing with the above-mentioned subjects, and thus build a basis for our subsequent discussion in Chapter IV and Chapter V. By matching the *past* and *future* aspects, we offer a dynamic overview of monetary and central bank developments that stretches over a long-term horizon. Chapter II contributes to this assignment by conveying several important messages.

Firstly, our analysis shows that a broad *political and social consensus* about the global reform strategy is essential if the transition is to be successful and less costly. Concretely, this means that a broad agreement about the transition action plan between the various factors in a society must be ensured for the reform plan to be implemented. Otherwise, the pressures of various political and social groups in the course of the transformation process can additionally encumber the reformers' tasks. Since those pressures are easily transmitted into wage, public expenditure and inflation increases, the costs of inflation inevitably rise, too. Ultimately, the speed of reforms decreases in parallel with the credibility of institutions executing the reform agenda such as, for example, the national central bank.

Secondly, the *credibility of programmes and institutions* is fundamental for a successful transition. Credibility can be achieved by (a) increased transparency in policymaking, (b) ensured consistency of the far-reaching real-sector reform programmes, and (c) secured democratic accountability. In other words, the political authorities should openly state their objectives and strategies for achieving them thus allowing the markets and the general public to make its own critical appraisals about their reputation. A prerequisite for such behaviour is, nevertheless, the establishment of a solid institutional framework.

Thirdly, an *adequate legal framework* remains the main mechanism for channelling discretionary policies. Practically, this is done by the introduction of certain institutional constraints, which should suppress the natural tendency of governing regimes to operate under discretion. This, however, should not happen at the cost of legal flexibility and the independence of the system's institutions. On the contrary, the main principle in the design of an adequate legal structure should be based on a balanced approach between the legal flexibility and legal restraints securing the accountability of democratic institutions. We believe that this is even more so in transitional times.

To what extent are those lessons applicable in the case of Serbia during its recent economic and monetary history (1989-2004) is the main question of our next chapter. But, in order to better understand how Serbia replied to the economic and institutional considerations of transition one must also know some basic facts about the Serbian post-World War II legacy. Chapter III will concern itself with outlining this legacy.

Chapter III Serbia's Economic Legacy – The Battle Against Inflation

3.1. Introduction

The main objective of this chapter is to document the thesis asserting that the design and timing of implemented economic programmes in Serbia (i.e. countries that Serbia was a part of in the period after the World War II) were greatly influenced by prevailing negative socio-political factors. Because of this phenomenon, the programmes have never delivered the expected results, contrary to the experience of other transitional countries. More generally, the chapter will demonstrate that international recognition is crucial for successful macroeconomic and monetary stability and overall transition.

From 1947 until, *de facto* mid-1991, Serbia formed a part of the Socialist Federal Republic of Yugoslavia (SFRY), a country which apart from Serbia also included five other constitutive republics: Bosnia and Herzegovina, Croatia, Macedonia, Montenegro and Slovenia.[1] In economic terms, from 1947 until mid-1950s, the SFRY and, therefore, Serbia, linked its economic activity to the realisation of annual production plans determined by the central plan. During the 1950s, however, the rigid socialist blueprint was abandoned and replaced by the central planning of the workers' self-management model. Many authors saw this new economic system as the most advanced and superior to all other social economic models because some of its features incorporated characteristics of market-oriented economic systems.[2] Petrović and Vujošević (2000) even claim that, owing to the implementation of the extensive market-based reforms in the early 1960s, the SFRY at the time exhibited certain features of what later become known as a transitional economy.

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[1] SFRY *de jure* existed until May 1992 when the Constitution of the Federal Republic of Yugoslavia was adopted ensuring legal continuation of the SFRY. But, *de facto* the SFRY ceased to exist when Slovenia and Croatia declared independence on 25 June 1991, which triggered military conflict between the formations of the Yugoslav National Army and local military formations of both Slovenia and Croatia. The conflict in Slovenia was over soon thereafter, but the civil war in Croatia, which spread to Bosnia and Herzegovina lasted until 1995, when the Dayton Peace Accord was signed.

[2] Petrović and Vujošević (2000, pp. 496 and 498) note that, unlike in the other countries of the Eastern bloc, institutional frame of a market economy at that time already existed in the country.

Long before the start of the transition process in the countries of the former Soviet bloc in 1989, the SFRY had shown greater integration into the international market scene, and as early as 1970 had established trade arrangements with the European Community (EC).[3] However, due to political tensions and military conflicts in Croatia and Bosnia and Herzegovina, the process of European integration was interrupted.[4] The collapse of SFRY followed as Slovenia and Croatia in June 1991, Macedonia in September 1991, and Bosnia and Herzegovina in April 1992 all unilaterally declared their independence. On 27 April 1992 Serbia and Montenegro formed the Federal Republic of Yugoslavia (FRY).

The period of FRY mostly coincides with the period of autocratic rule of Slobodan Milošević in Serbia, and the refusal of a part of the leading political structures in Montenegro to accept his political supremacy in the country from mid-1997 onwards (see Pavlowitch, 2002).[5] In practical terms, this meant that Montenegro began devising and arranging its own economic-political structure, selectively refusing to implement laws adopted at the common, federal level. At the same time, Serbia within the FRY was characterised by two sub-periods. The first sub-period, from April 1992 to September 2000, is characterised by political upheavals and civil wars followed by the exodus of civilians, international isolation, economic and other sanctions, the NATO bombing campaign, a pervasive downfall of the economic system and the deferral of transition. The second sub-period began on 5 October 2000 with the peaceful overthrow of Slobodan Milošević and his autocratic socialist regime (see Birch 2002). This was followed by the launching of the process of democratisation and economic stabilisation of Serbia.

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[3] The SFRY signed two non-preferential trade agreements with the EC in March 1970 and June 1973, respectively (see Temprano-Arroyo and Feldman, 1999, p. 784).

[4] A Trade and Co-operation Agreement (TCA) between the SFRY and the EU was signed on 2 April 1980 and was put in force on 1 April 1983. However, an Interim Agreement, implementing the trade provisions of the 1980 TCA, entered into force in April 1980. According to Temprano-Arroyo and Feldman (1999, p. 784): "After the break-up of the SFRY, the EU denounced the TCA of 1980, but continued to apply unilaterally its commercial terms to the successor republics. This is done through the so-called autonomous preferential trade regimes, which are renewed annually. Those regimes stopped applying to Slovenia and FYR Macedonia upon the entry into force of their TCAs. Also, the EU decided on political grounds not to renew in 1998 and 1999 the autonomous trade preferences to FR Yugoslavia".

[5] One should have in mind, however, that the period 1992-1997 was characterised by the close collaboration between the ruling Montenegrin government whose president was Milo Djukanović and the Serbian ruling Socialist Party of Serbia whose president was Slobodan Milošević (see Pavlowitch, 2002).

The institutional vacuum in which Serbia and Montenegro had separate political and economic regimes lasted until 14 March 2002, when the general agreement on the "Prelude Principles for the Rearrangement of Relations Between Serbia and Montenegro" – the so-called *Belgrade Agreement* – was agreed upon and signed by the representatives of Serbia, Montenegro and the FRY.[6] The Belgrade Agreement created the basis for the alteration of the FRY constitutional structure as it set forth the work on the Constitutional Charter of the State Union of Serbia and Montenegro, and the Law on Implementation of the Constitutional Charter.[7] After almost a full year of preparations, the parliamentary assembly of the State Union Serbia and Montenegro (SCG)[8] finally adopted the Constitutional Charter on 4 February 2003.

The adoption of the Constitutional Charter formally put an end to the existence of the FRY, thereby announcing a new era in the political development of the country. The new SCG administration become much smaller and performed fewer tasks compared to the FRY: its areas of competencies only include defence policy, foreign affairs, protection of human and minority rights, and some aspects of international and internal economic relations. The SCG appears to be particularly week in the economic domain, as the majority of responsibilities in the economic sphere lies in the jurisdiction of the two constituent republics. The point is best illustrated by the fact that the SCG does not collect its own revenues, depending rather on contributions by the republics (Box 3.1).

Thus, the new country – Serbia and Montenegro – has brought new concerns to political and economic analysis as it proved to be organised in a rather unique manner. To the political observes, the confusion arose from the fact that the Constitutional Charter contained a clause by which, after an initial 3-year period, a republic could chose to set up a referendum in which its citizens could vote independence. On the other hand, most economic analysts remain puzzled by the question of the functionality of a state with two parallel monetary, fiscal, customs and trade regimes.

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[6] The signatories of the document are: Vojislav Koštunica, President of the FRY, Miroljub Labus, Vice President of the Government of the FRY, Milo Đukanović, President of the Republic of Montenegro, Zoran Đinđić, Prime Minister of the Republic of Serbia, and Filip Vujanović, Prime Minister of the Republic of Montenegro. The agreement was signed in the presence of Javier Solana, High EU Representative for the Common Foreign and Security Policy. See Official Gazette (2003, pp. 95-98).

[7] Official Gazette of the State Union Serbia and Montenegro, No. 1/03.

[8] The acronym SCG stands for *državna zajednica Srbija i Crna Gora*, which is the formal name of the State Union of Serbia and Montenegro in Serbian language.

3.2. Serbia within the Socialist Federal Republic of Yugoslavia (1947-1991): Market Socialism

The SFR Yugoslavia makes an interesting case study for all those whishing to explore various 'facial expressions' of socialist regimes. Gros and Steinherr (1995) argue that this is due to the fact that SFRY, unlike other countries of the former socialist bloc, was more independent of the Stalinist regime, resolute to implement its own brand of socialism and more determined to overcome its inherited huge regional socio-economic differences. This Yugoslav-type of socialism is often referred to as the 'socialism with a human face' or as 'market socialism'.[9]

In pursuing these policies under the socialist federation, Serbia went through four different economic sub-periods. Based on Bošnjak (2002), the whole period form 1947 to 1991 can be divided in the following manner:

(i) The period of central planning (1947-1952)
(ii) The period of self-management and economic raise (1953-1965)
(iii) The period of market-oriented economic reforms (1966-1980)
(iv) The period of economic crisis and the beginning of transition (1981-1991).

Some authors, however, draw different distinctions. For example, Gros and Steinherr (1995, p. 324) distinguish two periods: (1) economic prosperity (from the 1950s until the end of the 1970s), and (2) economic stagnation and crises (lasting throughout the 1980s). Also, according to these two authors, Mencinger (1986) distinguishes four periods: (1) Soviet-type economic system (1945-1952), (2) mixed administrative self-managed market economy (1953-1962), (3) labour-managed market economy (1963-1973), and (4) the 'contractual' economy (since 1974). Furthermore, Savić and Pitić (1999, p. 10) offer the following division: (i) central planning (1945-1956), (ii) self-management (1957-1970), (iii) contractual economy (1971-1982), (iv) stabilisation and reforms (1983-1990), and (v) dissolution of SFRY market (1991-).

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[9] For example, see Gros and Steinherr (1995, pp. 320 and 324) and Steinherr and Ottolenghi (1993, p. 211).

3.2.1. Period of central planning (1947-1952)

Between 1947 and 1952, the economy operated under the classical social economic blueprint with the central plan at the core of the economic system. The concept included planners who set both the production targets and prices of produced goods in a manner described in the previous chapter. This Soviet-type economic system, however, started to be questioned soon after 1948 when President Tito[10] refused to remain under the umbrella of Stalinist political command. In economic terms, the consequences of such political decisions were, in the case of Yugoslavia, quite severe. By 1949, the SFR Yugoslavia was cut-off from all trade arrangements with the East European bloc, while at the same time it did not have established political or economic relations with the West.

Having in mind, though, that Yugoslavia preserved its independence from the political influence of the Stalinist regime, the political, economic and financial connections with the West were established relatively soon thereafter. In the meantime, however, the country had to develop its own economic habitat:

> "The Yugoslav version of socialism was markedly different from that in other socialist countries in Europe. The resulting socialist system acted as a unique laboratory where trial and error replaced the theoretical blueprint, the objective being to better the Stalin experience or indeed its promises for the future [...] Starting in 1948, Yugoslavia gradually abandoned its rigid command system and by 1952 the basis for social ownership and self-management was in place." (Gros and Steinherr, 1995, p. 328)

In economic terms, the period following World War II was characterised by great state investments in public works, post-war reconstruction and especially in electrification, industrialisation, and urbanisation. As a result, some great infrastructural projects relating to transport, electric power industry, telecommunications and oil pipelines were carried out. Also, the agricultural capacities were renewed, and provided an average GDP growth of 2 per cent per annum. The growth of domestic product in this period, however, pointed to the forming of its different structure.

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[10] Josip Broz 'Tito' was appointed the president of the provisional government and the Marshall of Yugoslavia in November 1943. In 1945, Tito became prime minister of the government of national unity after his Peoples' Front candidate list received majority of the vote. As a result, King Peter II was deposed and a republic was proclaimed with Tito at its forefront where he remained for full 35 years, until he died in May 1980.

The portion of industrial production in the domestic product increased from 17.8 per cent in 1947 to 21.1 per cent in 1952, whereas the share of agricultural production in the overall domestic product in the same period dropped from 39.6 per cent to 30.4 per cent. At the same time, this period was one of noticeable growth in foreign trade in comparison to the pre-war period, marked by an average annual import growth rate of 17.6 per cent, and, and export growth rate of 8.5 per cent. As a result of a constantly growing economy, the employment rate also increased by 8 per cent annually, bringing up a better standard of living to a larger number of citizens.

3.2.2. Period of self-management and economic raise (1953-1965)

The period after 1952 is important since the institutional framework for Yugoslav 'market socialism' began to be implemented throughout the country. The concept related to the social ownership of capital and other means of production, which were allocated on market-based principles. Social ownership made a key difference between the Yugoslav concept of 'market socialism' and 'market socialism' more generally, as it was applied elsewhere in Europe through a combination of state and private ownership.

This particular feature of the Yugoslav political and economic system is known under the names of self-management, labour management and worker management, since management of socially owned firms was the responsibility of various workers' representative bodies. The main critique of such a model hinges on the fact that social ownership corresponded to the formulation of non-ownership, as workers owing enterprises were allowed to accumulate their assets, but could not in any way sell those assets in order to increase their incomes.

In macroeconomic terms, the economy recorded very high growth rates that on average stood at 8.1 per cent.[11] Even agricultural production, which went through a recession in the previous period, achieved a high 4.8 per cent growth rate per annum.

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[11] Gros and Steinherr (1995, p. 324) argue that the percentage of an average GDP growth during the period between 1956 and 1964 was as high as 9 per cent. Steinherr and Ottolenghi (1993, p. 211) note that "the period from 1953 and 1965 was the most successful and dynamic one, the period of the Yugoslav 'economic miracle'...".

Table 3.1. *Relative growth performance*

	Average annual percentage change of GDP				
	1952 - 60	1960 – 70	1970 - 80	1952 - 80	1980 - 90
Yugoslavia	8.1	5.4	5.8	6.3	-0.3
Hungary	4.6	5.5	6.2	5.5	1.3
Czechoslovakia	4.9	3.5	4.7	4.3	1.4
Poland	4.6	6.0	8.7	6.6	0.0
USSR	6.1	7.4	6.1	6.6	2.3
Spain	3.6	7.3	3.5	4.9	2.8
Portugal	4.3	6.8	2.4	4.5	2.9
Greece	6.5	7.5	4.8	6.2	1.6

Note: [1] Net Material Product (NMP) for Czechoslovakia 1970-90 and USSR 1980-90; Gross Social Product (GSP) for Yugoslavia 1980-90.

[2] NMP represents the socialist equivalent of national income that excludes the value of most services (including government) that are unrelated to physical production. NMP measure is based on constant prices, which do not fully account for inflation, and excludes depreciation. GSP measures total output and roughly corresponds to GDP, but excludes certain items of which the most important is imputed income from ownership of housing (see Palairet, 2001, p. 904).

Source: Ottolanghi and Steinherr (1993, p. 219).

Such exceptional results even exceeded the OECD and EC countries' average growth rates (see Table 3.1). The recorded high average growth rates in the observed period mainly resulted from the high annual average employment rates of 5.9 per cent and increased investment efficacy. The period was also characterised for its relatively low inflation rate of 5.8 per cent and price stability, which induced savings and investments and supported a favourable balance of payment position. Still, the years 1961 and 1962 were marked by a slower economic growth caused by inadequate institutional changes and by "weak experience of the state apparatus with a market economy" (Bošnjak, 2002, p. 24). Similarly, even though 1963 and 1964 were marked by economic growth, growth of work productivity, investment efficacy and living standard, economic growth during this and the following years slowed down again due to inadequate implementation of the 1960 and 1965 economic reforms. Besides, the lack of a broad political consensus further weakened the country's economic performance.

3.2.3. Period of market-oriented reforms (1966-1980)

In institutional terms, the period after 1965 was marked by the abolishment of annual plans and introduction of medium- and long-term plans. The period until the adoption of the new constitution in 1974 was characterised by a gradual defiance of planning and the silent promotion of a market approach which, according to Gross and Steinherr (1995, p. 332), "reached its zenith around 1970". However, the Constitution of 1974 instaured the so-called 'contractual bargaining' between political and economic actors over the allocation of labour and capital, thereby marking a withdrawal from market-based economic principles.

In the period after 1974, some elements of a market economy existed, but they were not applicable in an environment of a collectively commanded economy.[12] One example is the establishment of a two-tier banking system, which was backed by the reforms of 1965. Formally, during this period, the SFRY's banking system was composed of a 'united monetary system' (Šević, 1999, p. 204), which included the National Bank of Yugoslavia (NBY) and the system of national banks of the republics and the autonomous provinces, and a number of 'commercial' banks.

Although the ownership over those 'commercial' banks remained either state or social, their direct role in financing enterprises increased remarkably. Banks mainly had a regional or local dimension since they were in the majority of cases founded by regional or local firms. They were obliged to financially support their clients – the same regional and local firms that owed them – regardless of their economic performance and profitability. As a result, financial allocation remained inefficient, albeit with a significant freeing of domestic prices and trade after 1965. This, in turn, led to the accumulation of bad debt arrears. Besides, according to Juselius and Mladenović (2002, p. 3), "these credits were given in domestic currency at the current official rate and were mainly associated with external borrowing and domestic savings held in foreign currency" that were introduced already in the early 1960s, to make the banking system more attractive.

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[12] Constitutional changes introduced in 1974 made a basis for disintegration of Yugoslav enterprises into its component Basic Organisations of Associated Labour (BOALs). According to Steinherr and Ottolenghi (1993, p. 215), this meant that "the mediation of economic decisions through markets was, to a considerable extent, replaced by inter-BOAL negotiation and bargaining among enterprises, industry and regional consultative councils, which were conduits for political intervention".

The period was characterised by rather unfavourable macroeconomic indicators as well. According to Bošnjak (2002, p. 25), in comparison with the previous period, the inflation rate more than doubled (in 1980 the inflation rate was 30 per cent), the GDP growth rate was reduced to 5.7 per cent (3.5 per cent in 1980), whereas the employment rate was 3.1 per cent. Even though the initial intention of the 1965 reform was to employ advanced technical equipment so as to improve work productivity and thus ensure an increase in the domestic product, this result was not achieved (see Bošnjak, 2002). Also, the economic structure did not change, while structural discord deepened further.

Emphasising the development of secondary industry, which caused the import of raw materials to grow faster than the export, terms of trade worsened, inducing the widening of balance of payments deficit. Parallel to this occurrence, savings rates were declining, putting additional pressure on the side of balance of payments financing needs. The consequent "Yugoslav foreign borrowing spree" (Palairet, 2001, p. 907), which ended in 1979, dramatically increased the total country's external indebtness. All this contributed to the overall worsening of the macroeconomic situation of the country in the period that followed.

3.2.4. Period of economic crisis and the beginning of transition (1981-1991)

The economic performance of SFRY in the 1980s differed enormously from previous experience. The beginning of the period was marked by the country's recognition that it could no longer finance its debt obligations. The problem reached its culmination at the end of 1982, and so the Federal Government in 1983 resorted to a specific set of reforms established under the "Long-Term Stabilisation Programme" (LTSP) policy framework (Gros and Steinherr, 1995, p. 326). New sets of traditional stabilisation policies combined with the resources allocation based on market principles, model was a central feature of the LTSP, which aimed to shift resources to net exports for a prolonged period of time in order to accumulate the financial means needed to service the foreign debt. Although the LTSP was not carried out consistently, during the period 1983-1989, the country's balance of payments situation improved, recording a surplus.

Even though the external position was stabilised, the economy recorded a low level of investment, which at first turned into stagnation and later into an overall decrease in economic activity and growth. The actual figures show that the rate of investment, which according to Gross and Steinherr (1995, p. 324) fluctuated around 30 per cent of GDP until the end of 1970s, fell drastically during the 1980s, amounting to approximately 20 percent of GDP (see Bošnjak, 2002, p. 26). During the period 1981-1990, the average annual GDP decrease rate was 0.4 per cent, which was followed by a reduction in the employment rate that turned negative as of 1987.[13] As a result, in 1990 the rate of unemployment reached a very high 17.2 per cent.

The set of traditional stabilisation policies that made up part of the LTSP relied on a tight fiscal and monetary policy. Constitutionally, the balanced budget was secured since the federal government was obliged to finance its expenditures up to the level of its revenues and was not allowed to borrow in order to finance any increased expenditures. Nevertheless, the quasi-fiscal deficits that existed among various enterprises owned by regional or local administrations were monetised because of excessive wage demand and thus fuelled inflation. Petrović and Vujošević (2000, p. 511) confirm that, during the 1980s, Yugoslavia's money supply accommodated wage instead of price inflation, suggesting that monetary accommodation in transition economies with dominant social sector and resulting soft budget constrains is 'institutionally specific'.

Under such circumstances, a tight monetary policy programme was needed in order to stop the acceleration of inflation, which in 1982 reached 32 per cent, whereas in 1988 and 1989, it amounted to 199 and 1,256 per cent, respectively. But, controlling monetary aggregates was difficult. According to Gros and Steinherr (1995, p. 327), this was due to the fact that between 40 and 50 per cents of bank deposits were denominated in foreign currency[14] which, in combination with a continuous local currency depreciation, led to automatic increases in the money supply. The authors also point out that, although at the time the central bank used reserve requirements and credit ceilings on bank lending as its main monetary instruments, it was unable to ensure full financial discipline and banks' compliance with those requirements.

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[13] According to Savić and Pitić (1999, p. 11) the employment rate turn negative as of 1990.

[14] Gros and Steinher (1995, p. 327) argue that "these deposits developed rapidly during the 1970s as a result of earnings from tourism and emigrants' remittances" since 1.2 million of workers migrated to the West.

In fact, if the central bank had pursued the restrictive monetary policy it had advocated, it would have closed the banks with large exposures to the loss-making enterprises, which would have led to the closure of those enterprises, too. Since from a political perspective this measure was unpopular, the central bank had to ease its monetary policy and accommodate credit expansion in order to ensure the liquidity of the system by printing more money. In institutional terms, it was easy to implement such an expansionary monetary policy, as the National Bank of Yugoslavia retained a low level of legal independence. Cukierman (1992, p. 381) calculated that during the 1980s the index of the overall legal independence of the NBY equalled to 0.13, which corresponds to the second lowest rank among 68 observed central banks, Switzerland being the top ranking country with the index of 0.68.

In such circumstances, the exchange and credit risks were borne by the NBY, which that acted as the lender of last resort. These losses accounted for a large portion of quasi-fiscal deficit that in turn perpetuated and accelerated inflation. In relation to this, Petrović and Vujošević (2000) indicate that the dinar loans that commercial banks awarded to companies during the 1970s (while inflation rate was relatively low) were based on external borrowing and domestic savings held in foreign currency. However, when the inflation rate went up during the 1980s, "large nominal currency depreciation wiped out enterprises' dinar debts, ultimately leaving foreign currency liabilities in the hands of the central bank and the government" (Petrović and Vujošević, 2000, p. 499). Furthermore, Lahiri (1991) finds that inflation in SFRY induced a considerable increase in the velocity of money, resulting in 80 per cent rate of inflation. Besides, the NBY policy to support economic activity by ensuring liquidity in the system, combined with a large proportion of deposits denominated in foreign currency, simultaneously led to inflation perpetuation during the 1980s (see Petrović, 1995).

The situation by the end of the 1980s worsened further, calling for a comprehensive systemic transformation of the enterprise ownership, a modification of the country's trade regime, the consolidation of federal/regional budgets and inflation stabilisation. As a result, in March 1989 the newly elected Federal Executive Council (FEC) presented its five-year "Economic Reform Programme" (see FEC, 1990), also known as 'Marković programme' which marked the SFRY's *beginning of transition.*

3.2.4.1. Critical appraisal of the 'Marković programme' (1989)

The significance of Marković programme is twofold.[15] Firstly, as we argued in the introductory chapter, this programme was the very *first* transition programme applied in Eastern Europe. Secondly, this programme is significant as it recognised the necessity of establishing of a *new* economic *system* instead of revising the old one, with the complete acceptance of international economic and political standards and opening towards the world. The programme, nevertheless, had one major fundamental drawback. Namely, as we shall see later in our work, this programme was never fully implemented, because of a lack of political consensus.

It is interesting to note that Marković already had clear and developed ideas about what steps needed to be taken in order to protect the country from a further economic downturn while before he become president of the FEC. Marković presented those ideas at the session of the Presidency of the Federal Conference of the Socialist Alliance of Working People of Yugoslavia[16] on 28 January 1989, when he stressed the following:

> "After much wavering we have finally realized that the causes underlying our crisis are manifold and that we cannot find a way out of it through revisions of the system. We have to create a new economically efficient and democratic society, an entirely new kind of socialism [...] It is evident that the way out of the crisis lies in reforms, which will proceed from an integral market, autonomy and rights of work organizations and economic entities to economic an development decision-making an responsibilities for such decisions and which will be based on opening to the world, with communication of not only goods but also know-how, technology, capital and people who would represent our fight to become part of the world, and also part of Europe by establishing connections with the most advanced developments." (FEC, 1990, p. 21 and 67)

Despite the fact that, at that time, the Yugoslav economy's most immediate and acute problem was spiralling inflation, the FEC stood at the viewpoint that the creation of an entirely new economic environment was the precondition for a successful fight against (hyper)inflation. This realisation is exactly what decouples the SFRY's transition programme from the other transition plans applied elsewhere in Easter Europe. We recall from the previous chapter that conventional wisdom required that the stabilisation agenda be carried out before a comprehensive set of structural measures could be implemented.

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[15] Ante Marković was the President of the FEC from 15 March 1989 until 20 December 1991.

[16] The Socialist Alliance of Working People of Yugoslavia [*Socijalistički savez radnog naroda Jugoslavije*] steams from the People's Front of Yugoslavia [*Narodni front Jugoslavije*] headed by Tito. See footnote 10.

According to FEC (1990, p. 69), the establishment of a new economic system implied the following: *first*, the building of new market institutions and mechanisms; *second*, identifying and resolving the issues surrounding the inherited large deficits of the state, banks and enterprises; *third*, adapting to the new market conditions of all economic agents (enterprises, banks, state institutions, individuals, trade unions); *fourth*, personnel changes and the strengthening of employee motivation through increased competitiveness; *fifth*, pursuing of a sound macroeconomic policy; *sixth*, formulating of a new concept and strategy of development.

The set of economic actions designed to address the above-mentioned problems can be grouped around the following ten points[17]:

(1) Battle against inflation;
(2) Financial system consolidation;
(3) Efficient state finance and fiscal system;
(4) Price and import liberalisation;
(5) Enhanced external economic relations;
(6) Setting up of a new business environment;
(7) Regulation of labour relations;
(8) Attention to social policy;
(9) Introduction of a new development strategy, and
(10) Enhanced economic growth *via* various neglected resources.

Nominally, these measures largely coincided with the measures suggested by Bruno (1993), Fischer and Gelb (1991) and the Washington consensus. By end-June 1989, some of them were partially implemented, as a number of systemic laws supporting the overall economic reforms were adopted. Among the set of adopted laws, the law on enterprises introduced the most radical changes into the economic system of the country by enabling the transformation of undefined ownership of social property into social capital, with a designated holder bearing the consequences of its economic decision.

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[17] These ten points were put forward by Prime Minister Marković in his speech delivered on 29 September 1989 at the occasion of the review of economic policy of that year, its implementing instruments, and a presentation of further anti-inflationary measures (see FEC, 1990, pp. 67-89).

Similarly, the Law on the National Bank of Yugoslavia of June 1989[18] aimed at the systematic improvement of the NBY's credibility, and at strengthening the financial discipline through a rigorous control of banks' debts and their restructuring. Likewise, the laws on accounting, foreign exchange operations, foreign economic relations and a number of other laws, from the point of view of the FEC, all incorporated anti-inflation components by ensuring increased security in economic transactions, deregulation and liberalisation of trade relations, and by building a market-oriented business environment.

However, while the federal government considered the transformation of the old arsenal of administrative measures as a precondition for fight against inflation, some economists considered it as a delayed implementation of much-needed stabilisation and anti-inflation measures. In relation to that, Savić (1989, p. 17) writes:

> "Furthermore, the calendar of measures and moves is seriously reproached, for such a conceived programme directly pushed the economy into hyperinflation. We might say that FEC did not act upon the generators of inflation, which are today [November 1989, auth. remark] the most intense, while their actions or mere announcing of their actions, and sometimes even neglect of the need for certain actions, directly contributed to a swift shift from a high inflation to hyperinflation."

It seems that views among economists over the right anti-inflationary strategy varied according to their diverging views on the underlining sources of the country's (hyper)inflation. The FEC argued that the causes were cost-pushed and demand-pulled mechanisms embodied in the very fabric of the economic system and, thus, structural.[19]

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[18] Official Gazette of the SFRY, No. 34/89, 88/89, 96/91 and 16/93.

[19] The FEC (1990, pp. 80-82) indicated the following as the main causes of inflation: (1) Inclusion of anticipated inflation in the price, which meant that the goods and services were sold at future prices rather than at prices which reflected the real costs of production, thus inducing spiral effect and increased expectations of further price rise; (2) Elevation of taxes and public welfare was caused by the impossibility to collect on time, at lower rates, from state-owned debtors, and as this elevation of taxes and contributions ultimately burdened the economy, and further on the prices of final products, it hurried the progressive inflation growth; (3) Rise of the primary issue and its utilisation for covering the fiscal deficit, and the inability of NBY to handle a firm monetary policy and control the monetary aggregate movement, which, over the first four months of 1989, caused the money supply to grow faster than the growth of prices mainly through new monetisation flows like irregular use of promissory notes, quasi-regular flows between banks and enterprises and among enterprises, illegal use of cheques, etc.; (4) Existence of extensive public consumption and expenditure, which were not financed from real sources; (5) Unidentified deficit of the public sector due to non-existence of a unified state budget; (6) Deficits in banks and enterprises; (7) Indexing of personal income to anticipated inflation; (8) Restricted terms of trade and existence of trade barriers which, in turn, limited competition and supply and allowed for formation of monopoly prices, and (9) Rigid concept and role of commodity reserves, which stopped the government from intervening efficiently on the market and suppress the growth of prices of certain commodities.

Although Savić (1989, p. 13) agrees that the inherited structural inefficiencies represented the core of the problem, he also emphasised that the "old concepts of defeating inflation and their classification into the inflation of demand, cost-push inflation, structural inflation, and other, are not longer sufficient and adequate". As a contrast, he argues that the causes of (hyper)inflation in the SFRY derived from private agents' inflation expectations and that, therefore, they should be analysed in the context of the theory of rational expectations. This theory, which was the leading economic theory in the late 1980s, is based on the assumption that all private agents use all available information in the formulation of their expectations over future rates of inflation, while at the same time not dominantly relying on the past experience.[20]

The author's view is also influenced by the solutions to fighting inflation applied during mid-1980s in Israel and in several Latin American countries like Argentina, Bolivia, Argentina, Brazil and Mexico. On the basis of those countries' experience, Savić (1989, p. 14) classifies the main generators of the SFRY's high inflation into the following three groups:

(i) Rational inflationary expectations of economic agents that are based on frequent changes in economic circumstances and on all available information,

(ii) Inadequate economic policy measures that accompany anti-inflationary measures (especially in fiscal domain and deficit financing), and

(iii) Problems of systemic nature that need structural adjustments in the fields of both economy and politics.

Additionally, the author points out that certain other actions by the FEC, and disengagement from its announced policy actions, also contributed to the inflation hike. In particular, he argues that the FEC's measure to limit personal incomes announced in October 1989, but not adopted provoked, in fact, a new inflation wave due to the rational expectations of the country's economic subjects and the adaptation of their business behaviour to the announced government measure.

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[20] The theory of rational expectations was pioneered by Muth (1961), whereas Lucas (1972, 1973), Sargent (1973), Sargent and Wallace (1976), and Barro (1976) developed this theory further (see Savić, 1989, p. 7).

Additionally, Savić (1989) underlines that the interest rate of 28 per cent set by the FEC as a sort of nominal anchor, together with an inflation rate of about 50 per cent, created heavy disturbances in the monetary and exchange rate policy. Moreover, he argues that the government's income policy, based on the free formation of salaries, which aimed at establishing a balanced cost of labour as a production factor, actually led to an uncontrolled rise of labour costs, induced further inflation growth.[21] The final objection relates to the inexistence of adequate nominal anchor(s) in a situation in which the suppression of inflationary expectations is required.

One should have in mind, though, that Savić (1989) directs his comments to the actions and performance of the FEC in the period from March to mid-November 1989, and that the FEC presented its anti-inflation programme only on 18 December 1989.[22] Nevertheless, the fact that the Marković programme failed to introduce firm stabilisation measures at the beginning of the transition process, stands at the heart of this programme's critique, because the prolongation of stabilisation alters from the general theoretical recommendations substantiated in the previous chapter.

Once introduced, however, the *anti-inflation programme* included a wide set of measures in the area of fiscal, monetary, trade, credit and wage policies as well as currency reform.[23] A favourable balance of payments position, large foreign exchange reserves of USD 5.8 billion, and strong external financial support, formed the basis for the introduction of the anti-inflationary package. It should be noted that these propitious macroeconomic parameters were only registered after Marković took over the FEC presidency and that the initial macroeconomic imbalances were more severe, as shown in the previous sections.

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[21] The authors of the OECD economic Survey for Yugoslavia (1990, p. 15) agree with this point, emphasising that the increase in real wages, which they estimated to be at around 20 per cent in the first eight months of 1989, represented an important cost-push factor: "A self-feeding process of runaway inflation developed in which producers selling on credit charged prices significantly above current costs in anticipation of expected losses arising from the erosion of real money value by the time of actual payment."

[22] We have seen in the introductory chapter that some authors, like Gros and Steinherr (1995, p. 319), neglect the importance of this anti-inflationary programme on the grounds that it was not as comprehensive as the Polish programme of 1990. Edwards (1992, p. 130), on the other hand, notes that "the liberalization and stabilization programs in Poland and Yugoslavia exhibit a number of striking similarities".

[23] This stabilisation programme differed from the previous partial stabilisations undertaken by various SFRY governments during the 1980s. According to Bruno (1993, p. 209) the stabilisation programme of 1985 was based on wage-price controls, while 1988 stabilisation policies relied on imposition of wage and credit controls. Both programmes, however, were seen as partially stabilising as restrictive fiscal policies were not pursued and so both programmes failed in bringing long-term stabilising effects.

Based on the country's favourable foreign exchange reserves position, the FEC was in a situation to design an exchange-rate based stabilisation programme which, together with Poland's stabilisation programme adopted two weeks later, on 1 January 1990, was the first major stabilisation and reform programme applied among transition countries. Concrete stabilisation measures included the establishment of:

(i) Convertibility of the dinar in the current transactions with foreign countries by introduction of a new currency unit 'convertible dinar'[24];
(ii) Sound and restrictive monetary policy, and
(iii) Restrictive policy of public sector wages and expenditure.

Even though it was the first and novel feature of the programme, *convertibility* was not seen as an aim in itself but as a means for achieving stable economic flows and sustainable development. The convertible dinar was pegged to the deutsche mark at an exchange rate of seven to one (12 convertible dinars to one US dollar). The idea behind the fixing of the dinar exchange rate to the deutsche mark lay in the extensive trade relations with Germany and the fact that, due to high inflation, most contract obligations were calculated in DEM. Moreover, as in the case of Poland, the nominal exchange rate was fixed for a period of six months, until 30 June 1990, after an initial maxi-devaluation "as a way of providing an anchor for the price system" (Edwards, 1992, p. 142).

The effects of the government decision to resort to the exchange rate as a nominal anchor were the following. Firstly, the measure sent a signal to enterprises that it would not be possible to accommodate prices through constant devaluation of domestic currency and that, therefore, enterprises would have to restrain cost and price increases if they were to remain competitive. Secondly, this decision aimed at restoring the citizens' confidence in domestic currency in order to support the credibility of the programme and suppress high inflation expectations, which was especially important in the short-run.

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[24] One new convertible dinar equalled 10,000 old dinars.

The second feature of the programme was the pursuance of a *restrictive monetary policy* exercised through a more effective control over the money supply during 1990. The target for the growth of net domestic assets (NDA) of the banking sector was fixed at 7 per cent and for M1 at 24 per cent.[25] Additionally, in order to contain the increase in liquidity registered at the beginning of 1990, the NBY instructed commercial banks to invest 700 million dinars in the NBY's bills, but at the same time it raised interest rate on mandatory reserves from 12 to 25 per cent, to prevent the squeeze in banks' profits.

Thirdly, until 30 June 1990 the stabilisation included *fixed nominal wages*. Wages were frozen at their level of 15 December 1989, although there were two adjustments officially estimated to raise average wages by 15 per cent in January 1990 over those of December 1989. It is interesting to note that, apart from SFRY, no other transition country opted to freeze wages in order to stabilise the economy, although "wage policies were an integral part of all stabilisation policies" (Sahay and Végh, 1995, p. 29).

Additionally, the programme assumed the imposition of a partial six-month *price freeze* that affected public utilities, (non-)ferrous metals and pharmaceuticals, comprising some 20 per cent of the consumer price index basket.[26] In addition, the price freeze was decreed for rents and other housing charges, mainly levied by local authorities, preceded by a considerable upward price adjustments in the course of December 1989, and was aimed at reducing distortions in the structure of prices (OECD, 1990, p. 61).

In parallel with measures taken in the monetary sphere, the government continued to apply its *restrictive fiscal policy*, by integrating off-budget items and extra expenditures of the public sector in a consolidated federal budget. This action of incorporation was officially estimated to cost around 3 per cent of GDP, the greatest part of which was to be covered by increased taxation and through the Oliveira-Tanzi effect[27] (Bruno, 1993, p. 210). Accordingly, the government introduced a special turnover tax of 3 per cent applying to all goods (except food) and of 5 per cent applying to a great number of services.

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[25] See OECD (1990, p. 62)

[26] Consumer price index (CPI) is a measure of the average change in prices over time in a market basket of goods and services. See Bruno (1993, p. 210).

[27] Oliveira-Tanzi effect is a synonym for delays in tax collections during the periods of high inflations leading to the widening of fiscal deficits to an extent equivalent to the rate of inflation increase (see Savić, 1989). Or, as Rostowski (1998, p. 109) puts it, that is the fall in the real value of conventional tax revenues.

The anti-inflation strategy itself, however, exhibited certain weak-points and to some observers seemed untenable (see OECD, 1990). This was so firstly because some remaining price pressures were still representing a threat to the sustainability of the programme. The second argument put forward by the OECD (1990, p. 64) is that "convertibility combined with a guaranteed exchange rate for a fixed period in the face of still high price rises by international comparison in the early months of the year could induce shift out of dinars into foreign currencies towards the end of the wage freeze and steep import growth". Namely, it was assumed that under those conditions, the balance of payments would exhibit a downward pressure on the exchange rate.

However, the authorities were aware of these drawbacks and were, therefore, paying extra attention to structural reforms. The aim was to restore domestic confidence and to enhance the positive results of the supply-side effects of reforms such as the increased financial discipline of enterprises and growing foreign competition. Moreover, the existing favourable level of official reserves of around USD 7.5 billion[28] had to play an important role in case of a possible increase of conversion from dinars to foreign currency. Since, at that time, the deutsche mark had already gradually replaced the dinar as a unit of account for most domestic transactions, the margin for shifting out of dinars was limited and was estimated to USD 1.5 billion, leaving enough space for official reserves to meet rising imports.

However, the Marković programme reached its maximum in September 1990 when – only nine months after its inception – it fell into a crisis. After a slim price increase of 0.3 per cent registered in May 1990 and negative inflation rate of 0.3 per cent in June 1990, inflation recorded a 7.3 per cent raise in September 1990. The programme was greatly affected by the illegal issuance of money by the National Bank of Slovenia and the National Bank of Croatia, which took place in October 1990, and by the National Bank of Serbia and the National Bank of Vojvodina in December 1990 (see Dinkić, 2000). The republican national banks were mainly granting liquidity loans to commercial banks above the collateral as prescribed by the National Bank of Yugoslavia.[29]

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[28] This figure corresponds to the end of February 1990 (OECD, 1990, p. 66).

[29] Granting of credits on the basis of collateral was prescribed by the NBY based on Art. 14 and 19 of the Law on the National Bank of Yugoslavia and the Single Monetary Management of the National Banks of the Republics and the Autonomous Provinces, Official Gazette of the SFRY, No. 34/89.

According to Dinkić (2000, 64), these "spectacular incursions into the monetary system" marked the end of the Marković's programme. The magnitude of the illegal[30] money issuance in Serbia alone was such that it equalled to one half of the total official money supply envisaged for 1991. As a result, the level of international reserves in December 1990 decreased by USD 1.5 billion, which is the biggest monthly fall in SFRY's international reserves ever registered.

The mechanism, as explained by Dinkić (2000, pp. 59-69), worked in the following way. In the late 1990 and early 1991 political tensions between republics took primacy and so the republican administrations were unwilling to comply with the proposed structural reforms. Even more, as the republics anticipated the disintegration of the country, they aimed at collecting large balances of hard foreign currencies. They included in their plans the republican national banks and payment bureaus (*Služba društvenog knjigovodstva – SDK*), which allowed commercial banks to use their mandatory reserves and overdrafts to buy as much foreign currency as they could. Later on, the commercial banks had been provided with so-called liquidity loans to 'cover' their negative money balances. Those loans represented the 'grey emission of money' by the republican national banks that, in the period from October 1990 to February 1991, equalled to: DEM 3.1 billion in Serbia, DEM 289 million in Montenegro, DEM 243 million in Croatia, DEM 143 million in Slovenia (see Dinkić, 2000, p. 68). The amounts in Macedonia and Bosnia and Herzegovina were negligible.

As a result, the macroeconomic situation in the SFRY worsened again during 1990. The country registered a large balance of payments deficit of USD 2.5 billion and a substantial foreign debt of USD 18 billion (Bošnjak, 2002, p. 26). Moreover, due to the disintegration of the Yugoslavia-wide market induced by political tensions, the GDP growth rate of 1990 exhibited a fall of 11.6 per cent in comparison to 1989, whereas the annual inflation in 1991 quickly reached a high 121.7 per cent (Dinkić, 2000, p. 33).

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[30] According to Dinkić (2000, p. 64), Serbia has legalised its action retroactively by adopting the Law on the Loan of the National Bank of Serbia to the Republic of Serbia and the Decree on Authorisation of the Loans for the Purpose of Securing Banks' Liquidity, both of which were published in the Official Gazette of the Republic of Serbia – Special Edition, No. 14/90, and labelled as 'top secret'. The confidentiality was based on the Article 14a of the Law on the Publishing of the Laws and Other Legal Acts (Official Gazette of the Socialist Republic of Serbia, No. 21/78 and 55/80) and the Decree on the Conditions and Conduct of Publishing and Handling of the "Official Gazette of the Socialist Republic of Serbia – Special Edition" (Official Gazette of the Socialist Republic of Serbia, No. 59/81 and 17/82).

It should be underlined that Marković's programme of 1989 was an exchange rate stabilisation programme, the elements of which resembled the basics of other transitional anti-inflation stabilisation programmes.[31] The major critique of this programme, thus, hinges on the fact that its implementation was delayed and fractional. It remains unclear, though, whether the lack of full implementation was only due to political or also due to economic considerations. Our analysis has shown that the Marković programme exhibited certain drawbacks on both fronts. With regards to political factors, we find that it was lucking strong political support, which undermined the credibility of the programme and the credibility of the institutions that were in charge of its implementation. Consequently, and in relation to the economic aspects, the programme failed as its stabilisation measures were prolonged and implemented only partially.

On a more technical side, the programme was considered to be comprehensive. Its first component aimed at the elimination of monetary disequilibrium (reduction of monetary overhang) through simultaneous (a) large nominal devaluation, (b) freeing of the vast majority of prices, and (c) declaration of the (partial) convertibility of national currency. Major price level adjustments happened almost automatically, but the fact that even after these price adjustments around 50 per cent of bank deposits were held in foreign exchange currencies points to the fact that the credibility of the programme was rather weak (Edwards, 1992, p. 138). Stabilisation in the SFRY also relied on an increased in interest rates, in order to control aggregate demand, and on tight fiscal discipline based on massive expenditure cuts and the reduction of subsidies to public firms. Additionally, the programme introduced a (partial) de-indexation of wages aiming at the reduction of inflation inertia through a decoupling of wage increases from the country's inflation experience. Moreover, after the large devaluation and the introduction of currency convertibility, the nominal exchange rate was fixed in order to provide an anchor to the price system. However, as the country experienced real exchange rate appreciation in 1990, which reduced the degree of its exports' competitiveness, the fixed exchange rate was abandoned by early 1991. Finally, the illegal incursions into the monetary system brought to an end the first transition stabilisation programme in SFR Yugoslavia and, incidentally or not, brought about the end of the country itself.

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[31] See Chapter I for the overview of main features of transition stabilisation programmes.

3.3. Serbia within the Federal Republic of Yugoslavia (1992-2000)[32]: Transition Suspended

One can argue that Serbia in the period between 1992 and 2000, being one of the two constituent republics of the Federal Republic of Yugoslavia, went through the most turbulent period in its modern history. After several decades of high economic achievements that lasted until the end of 1970s, and a subsequent decade of high inflation and external imbalances, Serbia during the 1990s stepped into an era of economic morass. Political developments, which took place during that decade, fully determined the economic (under)performance of the country, setting it tens of years back.

The 1990s were marked by a significant deterioration of economic activity, underpinned by international isolation and severe economic sanctions imposed on FRY by the UN Security Council, the US and EU administrations.[33] Apart from economic sanctions, civil wars, hundreds of thousands of refugees, and the loss of a broader Yugoslav market, have all contributed to the interruption of the transition process in general. In the period between 1992 and 2000, Serbia also experienced the blistering episode of NATO raids and an extraordinary, revolutionary event dubbed the 'bulldozer revolution'.[34] Most of those events, however, only related to the Republic of Serbia and thus we exclude the Republic of Montenegro from our further analysis.

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[32] Legally, the FRY lasted from 27 April 1992 until 4 February 2003.

[33] The sanctions were imposed on all commercial and financial transactions between the FRY and the rest of the world. The embargo was extended to include sports and cultural activities. Also, a rather strict regime of working, business and travel visas was introduced for all FRY's citizens travelling to Europe and the United States. Undoubtedly, all this further encumbered the process of economic transformation of the Yugoslav society and economy, greatly hindering the renewal of FRY's linkages with the developed countries. The sanctions were in force in the period between 1991 and 2001. However, the exact chronology of legal measures introduced by the UN, EU and US is somewhat complex and it is, therefore, not presented here. For a detailed analysis of sanctions imposed on FRY see Bošnjak (2002, pp. 78-97).

[34] The term represents a synonym for turbulent period surrounding the FRY presidential elections of 24 September 2000. In relation to this, Birch (2002, p. 507) writes the following: "On 4 October the Constitutional Court released a statement claiming that the presidential elections were partially annulled and suggested that they would have to be re-held at a later date prior to the expiration of Milošević's official term in July. This infuriated the opposition, which issued an ultimatum; if Milošević did not step down by 3.00 pm on 5 October, Serbian citizens were to storm the federal parliament building. This is exactly what happened. A crowd estimated at between 500,000 and a million from all over Serbia gathered before the parliament. [...] The crowd stormed the parliament building, followed soon thereafter by the headquarters of Radio Television Serbia, where a front-loader was used to break the police cordon (whence the moniker 'bulldozer revolution')."

Based on the above-mentioned facts, we divide the observed period into the three distinct sub-periods:

(i) Hyperinflation and economic destruction (1992-1998)
(ii) Economic aspects of the Kosovo conflict and the NATO raids of 1999
(iii) The 'bulldozer revolution' and the year 2000.

It is beyond any doubt that the Serbian episode of hyperinflation was the most intriguing from the monetary point of view and so the vast part of this section deals with that particular issue. Besides, hyperinflation as such represents a universal problem, whereas the other events mentioned here are more country-specific. Therefore, the section outlines the causes and consequences of Serbia's hyperinflation and critically appraises the stabilisation programme that followed. Also, based on an analysis of macroeconomic parameters registered during 1999 and 2000, the section concludes that the ten years have basically been lost and that the country only started catching up with the rest of transition countries in 2001.

3.3.1. Hyperinflation and economic downfall (1992-1998)

The recession that Serbia faced in 1990 led its economy into a depression in 1991, which continued for a few years. Table 3.2 shows that the period between 1991 and 1993 registered a sharp decline of growth rate, which in 1991 was -10.9 per cent, in 1992 equalled to -31.9 per cent, and in 1993 amounted to -30.8 per cent. In addition, Bošnjak (2002, p. 28) calculates that the degree of production capacities usage in 1993 was only 30 per cent, which was about 50 per cent lower then in 1990 when the degree of usage stood at 62 per cent. Such a low degree of economic activity was enough to secure only basic citizens' needs and to provide a minimum functioning of public services.

Moreover, as shown in Graph 3.1, statistically registered GDP in 1993 was about 60 per cent lower than the GDP recorded in 1989. Graph 3.1 also illustrates the deterioration of productivity, which in 1993 was just slightly over 40 per cent of the 1990 productivity rate. It is our view, however, that in an economy hamstrung by severe economic sanction, this occurrence appears inevitable.[35]

Although faced with difficult social-economic circumstances, formal employment in Serbia was artificially maintained because of the fear of possible social outrage. However, due to a decrease in growth and productivity rates, the standard of living recorded a significant drop. Per capita income decreased by about 50 per cent in just one year, from USD 2,000 in 1991 to only USD 1,000 in 1993, as shown in Table 3.2.

Additionally, due to the economic sanctions and loss of business connections with Western European trading partners, the exchange of goods with the rest of the world was drastically reduced. According to Bošnjak (2002, p. 46), during the 1991-1993 period, the exports of goods fall by 20.5, and imports by 25.9 per cent. The export/import structure transformed as well. The share of low-scale manufactured products significantly increased, whereas the portion of final, high-scale manufactured products decreased in the total export numbers. Moreover, there was a significant reduction of equipment allotment in the import structure, which contributed to the drop in domestic products quality and resulted in a substantial decrease in their international competitiveness.

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[35] In contrast, Palairet (2001, p. 908) notes that "the extent to which trade sanctions brought about economic decline is debatable, because of the inefficiency, corruption and cynicism with which they were administered".

Table 3.2. *FR Yugoslavia: annual economic indicators (1991-1993)*

	1991	1992	1993
Inflation (retail prices) (%) [a]			
Annual average	117.8	8,954.3	1.16×10^{14}
Monthly average	10	55	1,011
Monthly average annualised	234	1913	1.15×10^{36}
GDP ($ billion) [b]	23.2	15.8	10.9
Growth rate (%)	–10.9	–31.9	–30.8
GDP per capita ($)	2,000	1,500	1,000
Money M1: end of period (% GDP)	6.9	2.8	0.2
Inflation tax on M1 (% GDP)	16	15	22
Seigniorage on base money (% GDP)	10.4	9.6	10
Real exchange rate (1989 = 100)	67	112	733 [c]
Tax revenues (% GDP) [d]	34	20	13 11
Government expenditures (% GDP) [d]	47	41	47 39
Fiscal deficit (% GDP) [d]	13	21	34 28
Exports of goods and services (% GDP)	25	20	
Of which goods	20	16	
Imports of goods and services (% GDP)	26	27	
Of which goods	24	25	
Net imports of goods and services (%GDP)	0.8	7	
Of which goods	4	8	
Net transfers	–2	–6	

Note: [a] Inflation rates are calculated as differences of natural logarithms as in Cagan (1956)

[b] As in most Eastern European countries, the Yugoslav Statistical Office used and regularly reported the material balances definition of "social product," i.e., it excluded health, educational, financing, housing and other services. However, the Statistical Office made an estimate of GDP in 1994; starting from this estimate we find that a good approximation of GDP for the period 1991 to 1993 would be to increase the corresponding "social product" by a factor of 1.15. In this paper GDP is primarily used to obtain various shares, and these shares are not sensitive to increasing "social product" by a factor of 1.1 or 1.2 as compared to 1.15.

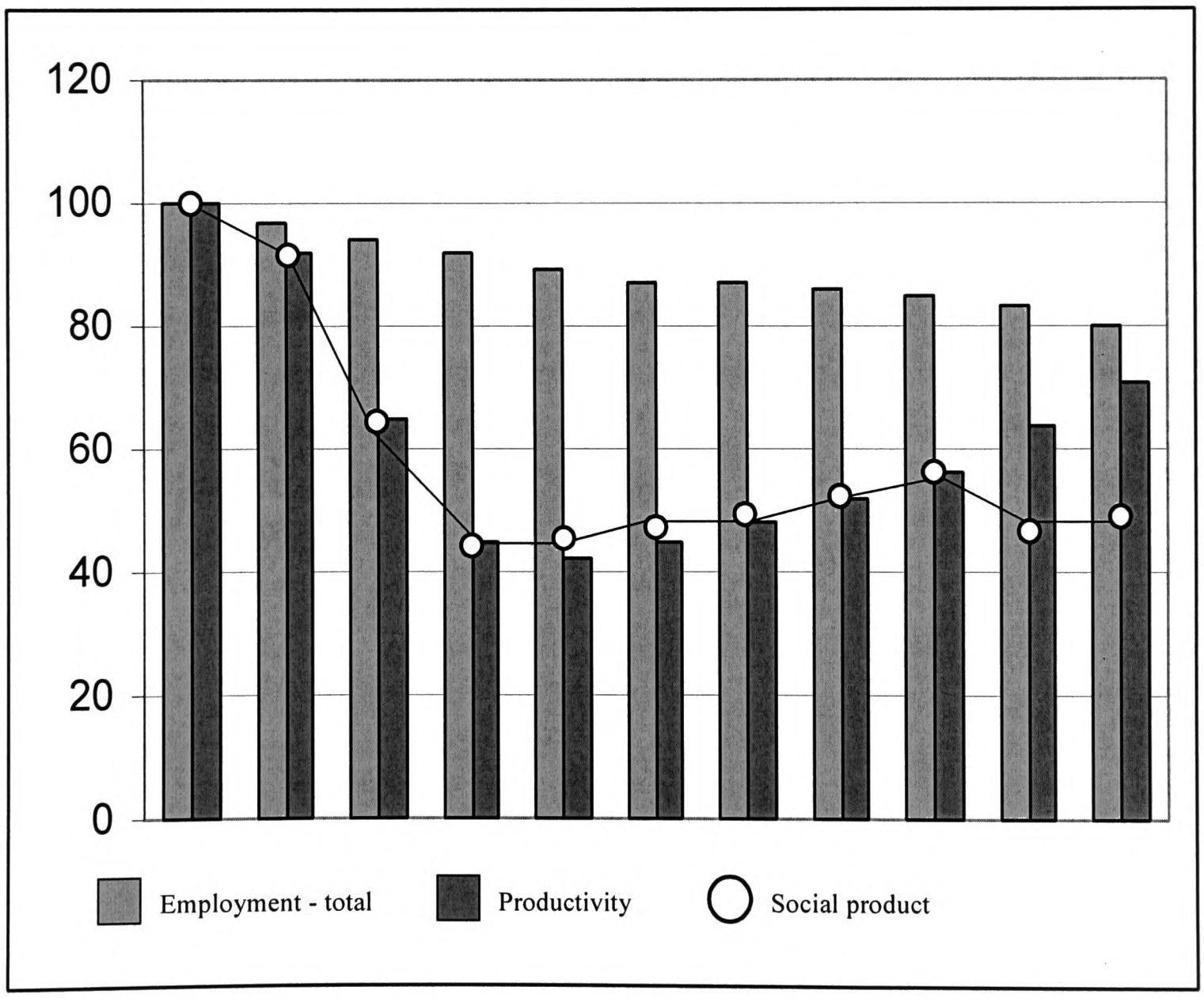
[c] An increase in the real exchange rate index signifies real exchange rate depreciation. When December is excluded from the estimate of real exchange rate, the number is much lower at 156. We are inclined to take this lower figure as a measure of the real depreciation in hyperinflationary 1993, as the official estimate of the inflation rate in December 1993 is somewhat unreliable.

[d] For 1993, the first column shows the estimate of the Federal Government, while the second column gives the estimate of the authors. The official estimate is distorted, in our opinion, by improper accounting of extreme hyperinflation in 1993. Therefore we offer our correction of official estimate, but nonetheless we report both estimates.

Source: Petrović *et al.* (1999, p. 339).

The crucial macroeconomic problem at the beginning of the 1990s was high and swelling inflation. Namely, the inflation annual average in 1991 stood at 117.8 per cent with a monthly average of 10 per cent (see Table 3.2). The same table reveals that the corresponding figures in 1992 were significantly higher – that is 8,954.3 percent and 55 per cent, respectively. At that point, Serbia's high inflation turned into hyperinflation. Based on the official data, published by the Federal Bureaux of Statistics, Popović and Stamenković (1994, p. 5) note that prices in December 1993 went up by more than 179 thousand per cent. As a result, ending 1993 and entering 1994 the Serbian economy marked a monthly inflation rate of over 300 million per cent.

Graph 3.1 *GDP employment and productivity (indices 1990=100)*



Source: Bošnjak (2002, p. 53).

Inflation reached its peak in January 1994 when FRY recorded a rate of 313 million per cent per month. Even though the data unquestionably reached high figures, some authors believe that the data was overestimated and that the appropriate figure was 58 million per cent, which was the black market exchange rate depreciation.[36] Regardless of whether the Yugoslav monthly rate of inflation reached 58 or 313 million per cent, the hyperinflation was placed into a historical contexts as the second highest (after the Hungarian hyperinflation of 1945-1947) and the second longest (after the Russian hyperinflation of 1922-1924)[37] hyperinflation ever recorded in global monetary history. The comparative figures are given in Table 3.3.

Table 3.3. *Eight hyperinflations of the 1920s, 1940s and 1990s*

Country	Beginning	End	P_T/P_0	Average monthly inflation rate %	Average monthly money growth %
Austria	Oct. 1921	Aug. 1922	70	47	31
Germany	Aug. 1922	Nov. 1923	1.0×10^{10}	322	314
Greece	Nov. 1943	Nov. 1944	4.7×10^{6}	365	220
Hungary I	Mar. 1923	Feb. 1924	44	46	33
Hungary II	Aug. 1945	Jul. 1946	3.8×10^{27}	19,800	12,200
Poland	Jan. 1923	Jan. 1924	699	82	72
Russia	Dec. 1921	Jan. 1924	1.2×10^{5}	57	49
Yugoslavia	Feb. 1992	Feb. 1994	1.6×10^{21}	19,395	-

Notes: P_T/P_0: Price level in the last month of hyperinflation divided by the price level in the first month.
Source: Blanchard (2000, p. 447), Dinkić (2000, pp. 36, 43), Nielsen (2004, p. 6), Rostowski (1998, p. 88).

The period between 1991 and 1993 in Serbia was also characterised by an active role of quasi-state banks, which operated on the principles of pyramidal banking and which enjoyed full state support. The core of their business was the weekly building up of nominal interest rates at the expense of newly attracted deposits, which further spurred inflation.[38] The two most important examples include *Jugoskandik* and *Dafiment banka*.[39] Their failure to repay the deposits and related interests upon their collapse heavily burdened an already weakened domestic currency, banking system and state budget.

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[36] See Petrović and Mladenović (2000, p. 787) and Petrović *et al.* (1999, p. 338).
[37] Our data is based on Petrović *et al.* (1999, p. 336). Rostowski (1998, p. 88), however, claims that Nicaragua (1987-91, 48 months) and China (1947-9, 26 months) experienced longer hyperinflations.
[38] On the role of the quasi-state banks in creation of speculative financial flows of the country, the most extensively wrote Dinkić (2000, pp. 151-231).
[39] According to Dinkić (2000, pp. 33 and 35), *Jugoskandik* was operating from January 1991 until March 1993 and *Dafiment bank* from October 1991 until April 1993.

It was clear at that time that the National Bank of Yugoslavia was not independent from political pressures and that it did not enjoy citizens' trust. In other words, it lacked credibility. Therefore, it is not surprising that some authors advanced the thesis that the central bank needed to be replaced by a currency board.[40] Hanke and Schuler (1991a) were the ones who actualised the idea of a currency board in Yugoslavia. We note, though, that during the first half of the 1990s, the same authors proposed similar solutions to a number of other formerly centrally planned economies.[41]

Their paper starts with an explanation of the basic principles of a currency board arrangement, whereas in the second part of their study the authors propose a model of a currency board law for Yugoslavia. Their main argument in favour of a currency board over a central bank is the existence of a fixed exchange rate of the domestic currency in relation to the specific foreign ('hard') currency and the existence of money supply, which is 100 per cent backed by foreign exchange reserves. In addition, Hanke and Schuler (1991a, p. 17) argue that "in the currency board system, the amounts of loans that banks can create (and thus the total money supply) are limited by their ability to secure and hold sufficient reserves as the base for loans".

Having in mind the fact that in the currency board system the exchange rate is fixed, the authors attribute a number of advantages to this monetary arrangement. First, they underline that the elimination of exchange rate risk stimulates international trade, which further encourages economic efficacy and foreign investments. Second, under the currency board, access to the financial markets of a backup currency country is eased, thereby fostering the economic growth. Thirdly, within a currency board, a fixed exchange rate ceases to be the subject of political agreement and becomes a feature of the economic environment.

The question, however, remains as to whether the fixed exchange rate is the main advantage of a currency board arrangement and why it is necessary to abolish the central bank, which can also adopt a fixed exchange rate. In answering this question, Hanke and Schuler (1991a) underline that this is due to the inability of a central bank to *maintain* the fixed rate due to dynamic inconsistency.

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[40] See Hanke and Schuler (1991, pp. 11-12).

[41] See, for example, Hanke and Schuler (1991b), Hanke and Schuler (1991c), and Hanke and Schuler (1994).

Even though there are indices, based on the above-mentioned arguments, that such a currency board solution could have led to the calming of inflationary tensions in FRY at that time, the idea was deemed too radical and rejected by policymakers immediately after its launch.

Interestingly enough, Yugoslav academics opposed this idea, with a time lag of about eight years, in 1999. They argued in favour of a central bank over a currency board.[42] Iglić (1999, p. 23), for example, claims that the "existence of serious limitations to the introduction of the currency board arrangement, and the shortcomings of the very arrangement, compared to its advantages, clearly speak in favour of sustaining the central bank institution [...]". Similarly, Lučić (1999, p. 21) claims that "a currency board is not an adequate solution for Yugoslavia", stressing that solid money is an important but insufficient requisite for growth and development of an economy, and that it is important for all economies to have an appropriate sum of money in circulation. Savin (1999) also believes that the replacement of the National Bank of Yugoslavia by a currency board is inappropriate, as the Yugoslav economy does not meet the necessary requirements.[43] Finally, Ognjanović (1999, p. 21) argues that the currency board is in fact based on two projections:

> "The first is based on the thesis of distrust in knowledge and competence of national, domestic institutions and national systems to adequately manage and carry out the monetary policy. The second is based on the illusion that the entire economy of a country could be put in order and economic prosperity, by mere monetary policy actions".

Broadly speaking, Ognjanović's (1999) work contributes more to the general spreading of the idea of sustaining national monetary institutions than it contributes to the understanding of the essence of a currency board arrangement. Still, this paper is significant as it represents the most critical review of the idea of introducing currency board in Yugoslavia.[44]

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[42] Even though this occurrence seems utterly symptomatic, it is not clear why is this so.

[43] According to Savin (1999, p. 7), foreign currency reserves are insufficient, the banking system burdened by large 'imperfections', export uncompetitive and burdened by a trade deficit. On the other hand, the main prerequisites for a successful functioning of a currency board are: large foreign currency reserves, healthy banking system and trade balance surplus, over which the growth of foreign currency reserves and, therefore, money supply increase would be ensured.

[44] Vuk Ognjanović was the NBY governor in the period from 17 July 1992 until 15 July 1993.

Toward the end of 1993 it was evident that the Yugoslav economy had entered a state of hyperinflation, urging for stabilisation measures. During this period, the dinar nearly completely lost its medium of exchange function, on top of the fact that the national currency already registered a substantial loss in its store of value and unit of account functions. What is crucial for our study, however, is the fact that such a macroeconomic environment was in a way supported by institutional changes reflected in the position of a supreme monetary institution and the entire banking system that took place in mid-1993, when the new Law on the National Bank of Yugoslavia and the Law on Banks and Other Financial Organisations were adopted[45] (see Chapter V).

3.3.1.1. Critical appraisal of the 'Avramović programme' (1994)

Given these circumstances, the FRY introduced the "Programme of Monetary Reconstruction and Economic Revival of Yugoslavia" (PMR) (see Avramović, 1994). The Federal Parliament adopted the programme on 12 January 1994, forming at the same time an expert team for the PMR implementation. Dragoslav Avramović, who was the head of that expert team, was soon thereafter appointed the NBY governor.[46] Officially, the programme's implementation started on 24 January 1994, even though at the time neither the Federal nor the Serbian Parliament was in session, nor did the NBY, which had the central role in this programme, have a governor. Nevertheless, the authorities began to implement the stabilisation programme, based on the following understanding of the main fundamentals of Yugoslavia's hyperinflation.

Rostowski (1998) cautiously argues that two factors drove the Serbian hyperinflation of 1992-1994. One is the sharp fall in real money balances, which brought the total real domestic money supply to amount to less then USD 4 per capita at the end of hyperinflation despite of which the seigniorage revenue[47] has remained rather stable. The second force was the Oliveira-Tanzi effect, which the authorities unsuccessfully tried to overcome by shortening the periods of tax collection and increased tax rates.

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[45] See Official Gazette of the Federal Republic of Yugoslavia, No. 32/93.
[46] Dragoslav Avramović was the NBY governor from 2 March 1994 to 15 May 1996.
[47] "Seignorage is equal to the product of money growth and real money balance" (Blanchard, 2000, p. 450).

Analysing the causes, dynamics, and money supply processes in the case of Yugoslavia's hyperinflation in 1992-1994, Petrović, Bogetić and Vujošević (1999) try to answer three questions. Firstly, they investigate whether a monetary or a balance of payments view better explains Yugoslavia's hyperinflation by posing the following question: was excessive money supply growth or currency depreciation the driving force behind hyperinflation? The second question they put forward is whether the money supply process was an endogenous process or one that grew mainly in an unpredictable, exogenous fashion? The third question asks what was the role, if any, that exchange rate-based pricing played in the Yugoslav hyperinflation, bearing in mind the monetarist proposition that prices are set in the money market?[48]

During the period of hyperinflation, the fiscal deficit increased from 3 per cent of GDP in 1990 to 28 per cent of GDP in 1993, reaching 71 per cent of total expenditures. At the same time, the real level of tax revenues in 1993 fell to just one-sixth of its 1991 level. Additionally, the seignorage on base money used to finance the fiscal deficits throughout the period was quite significant. It equalled to 10 per cent of GDP, which is similar to that of 1991, i.e. 13 per cent. However, the authors find that "the money supply did not target the amount of revenue needed to cover the given fiscal deficit, as suggested by Sargent and Wallace (1973), but instead reacted in a disorderly manner while monetizing the large number of local deficits" (Petrović *et al*, 1999, p. 341).

This leads to the conclusion that money supply was exogenous, i.e. unpredictable, by either inflation or currency depreciation, and that money supply growth exhibited a 'random walk monetary standard'.[49] Furthermore, the evidence confirmed that excessive money growth fuelled hyperinflation, implying that the monetary view explains the Yugoslav hyperinflation better than the balance of payments view. The process was happening, however, through exchange rate depreciation, which suggests that prices were not set in the money market, but that "they were indexed to the exchange rate" (Petrović *et al.*, 1999, p. 350). Such a view of the role of exchange rate-based pricing was also supported by the widespread everyday use of the DEM.

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[48] The authors base their work on exploration of the money supply process advanced by Sargent and Wallace (1973) who suggested "that, during hyperinflation, the government resorts to money creation to finance a given fiscal deficit in real terms" (Petrović *et al*, 1999, p. 336).
[49] See (Petrović *et al*, 1999, p. 351)

Petrović and Mladenović (2000) further explored the role of the exchange rate during hyperinflation. The authors tested a modified and advanced Monetary Model of Exchange Rate Determination (MMER) for Yugoslavia's hyperinflation of 1992-1994. Their main aim was to explore whether the exchange rate in Yugoslavia at the time was affected by prices as the MMER states, or whether it was determined directly by the money supply and demand, as studies of the MMER under the rational expectations would suggest.

The evidence from their paper supports the hypothesis that "the exchange rate under hyperinflation is determined directly in the money market, without any reference to prices" (Petrović and Mladenović, 2000, p. 803). The explanation for this lies in the fact that during hyperinflation the population bases its calculation on the exchange rate, rather than on price indices. This becomes obvious if one takes into account that an exchange rate is widely used and well understood by the general public during hyperinflation and, therefore, is set in market without error. Consequently, the domestic currency is replaced by the foreign currency and all prices and incomes are expressed in foreign currency, a phenomenon known as 'dollarisation' (see Chapter IV).

Much anecdotal evidence suggests that such a situation was indeed recorded in FRY in 1993, when the dinar was only used for tax payments, whereas private agents exchanged goods in the markets exclusively with foreign currencies (i.e. DEM). The severity of the crisis made the Yugoslav government opt for a structured orthodox stabilisation programme based on the removal of fundamental macroeconomic debalances through the implementation of monetary and fiscal policy actions and adequate policing of the exchange and interest rate.

However, an evaluation of the situation was such that that the programme needed sequencing. The PMR concept, thus, included the following three phases: (i) monetary reconstruction and anti-inflation measures phase, (ii) primary recovery phase, and (iii) transition and structural adjustment phase (see Avramović, 1994). The first two stages needed to be implemented without delay under the closed-economy regime and under the effect of international community sanctions, while the third stage would only be able after the alleviation or cancellation of economic sanctions and the legitimising of the FRY in the international trade and financial markets.

The most important measure taken by Avramović's *exchange rate policy* was the suspension of the 'old dinar' issue on 17 January 1994, seven days before the actual PMR application, and the issuance of the 'new dinar' that began on 24 January 1994. Further on, two days after the introduction of the new dinar, a fixed parity between the new and the old dinar was formed in the 1:12,000,000 ratio, at the same time determining the conversion parity of the new dinar toward the DEM in the 1:1 ratio. This way, the PMR actually established a dual currency system in Yugoslavia comprised of old and new dinars. However, as the currency parities remained unchanged and were accompanied by the equalled interested rates, it was practically one currency. One should, nevertheless, keep in mind that the exchange rate was formed freely, based on the supply and demand of foreign currency under the crawling peg system.[50]

Even though the PMR measures linked to the exchange rate were most in evidence, the more fundamental part of the programme related to those measures taken in the *monetary policy* domain. The core of the programme was *remonetisation* (increased real demand for domestic currency), for the purpose of which all of the primary money issue was fully backed by foreign currency reserves of the NBY amounting to approximately DEM 500 million. Additionally, remonetisation included the free purchase of convertible currency from citizens and companies in an estimated amount of about DEM 150 million for the first trimester of 1994.[51]

In the first six months of the programme's implementation, the fiscal deficit of the consolidated balance of all public expenditures was covered by the issue of new dinars in the amount of 147 million new dinars per month. However, administering the monetary policy required, beside the establishment of the above-mentioned parities, the introduction of a single real positive discount rate and the cancellation of selective investment.[52] The programme also included the establishment of an obligatory external audit system for all banks and the adoption of an operational schedule for banks and enterprises rehabilitating and restructuring their debts.

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[50] The programme predicted that "the foreign exchange rate set according to the crawling peg system would be a single exchange rate applicable to all transactions (including payment of customs duties and allocation from foreign exchange reserves towards importing certain products)" (Avramović, 1994, p. 12).
[51] See Avramović (1994, p. 23)
[52] The banks were given the possibility to finance programmes "in line with their own credit policies and to be refinanced by the National Bank of Yugoslavia" (Avramović, 1994, p. 12).

Within the mentioned PMR, the entire concept of *fiscal policy* was built on the non-existence of foreign financial support.[53] The PMR was based on projected fiscal expenditures not exceeding 40 per cent of GDP in the first three months of implementation, and a total fiscal deficit of not more than USD 330 million. For the other nine months of 1994, the PMR anticipated a reduction of total public expenditures to 5 per cent of GDP with the budget deficit financing *via* the state's borrowing on the capital market. In the meantime, fiscal policy reform was supposed to ensure an increase in public revenues, since the expenditure side of the budget could not be further reduced. The fact that stabilisation was achieved without a balanced budget "cast doubt on Sargent's (1986a) argument that balanced budgets are necessary to establish the credibility which is needed for stabilizations to succeed" (Rostowski, 1998, p. 87). Instead, fiscal reform relied on a reduction in tax rates on the basis of an expanded tax base and a conversion of illegal economic activities into the legal flows.[54]

Taking into account that Yugoslavis's hyperinflation was considered classical, and the method of knocking it down orthodox, the proposed PMR did not imply interventions in the *wage* and *price policy* domain. In accordance with this, the programme had foreseen that wages would be formed freely, without control, and that in the monopolies and public enterprises they should be accorded with the movement of wages in the rest of the economy. Similarly, prices of all kinds of goods and services could be formed freely. The exemptions related to the selective price controls conducted in public enterprises that produced public goods, offered public services or were highly dependent on imports.

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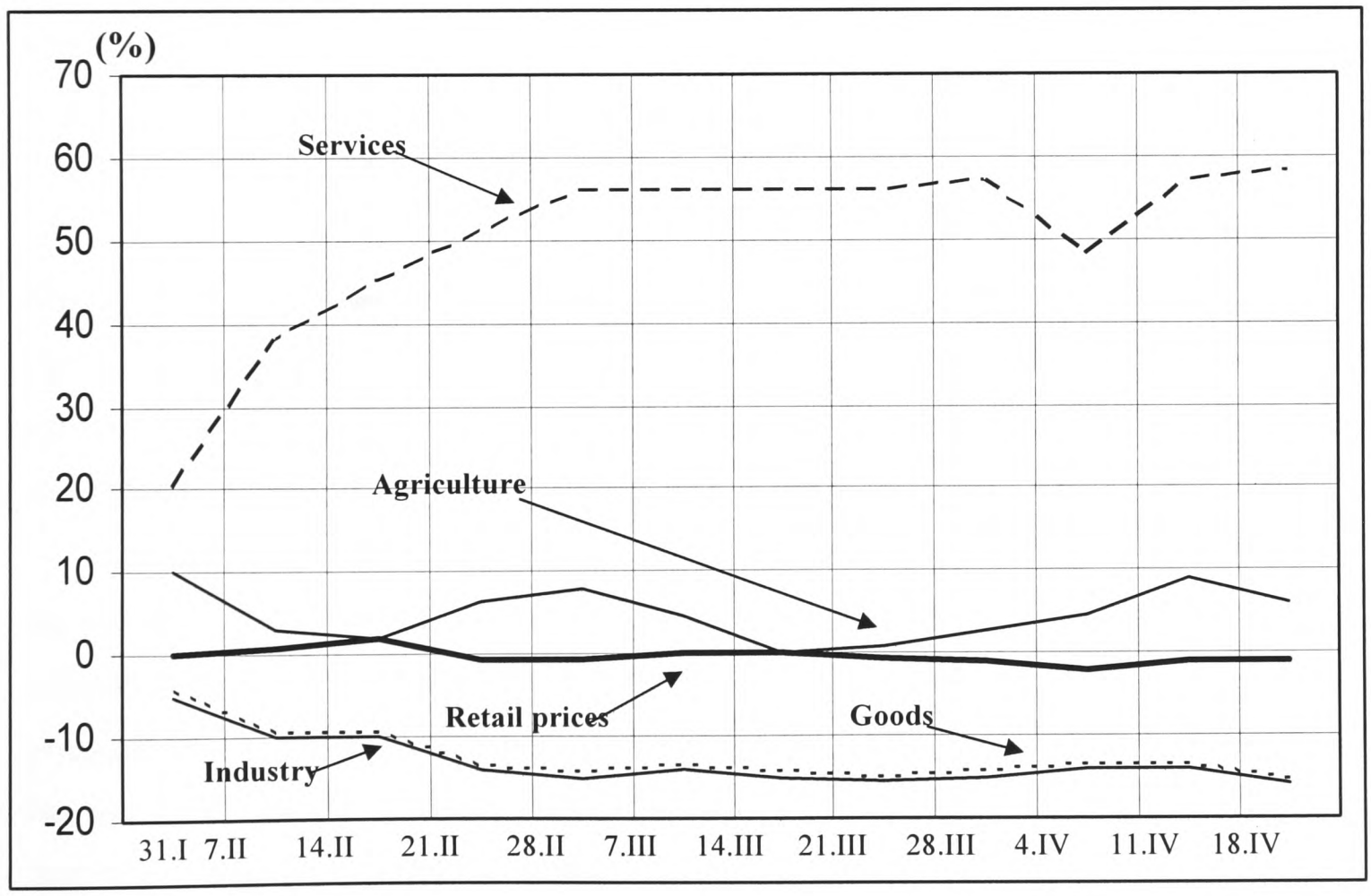
[53] According to Avramović (1994, p. 9), "with a view to obtaining foreign financial support, the Federal Government addressed the IMF, World Bank and European Bank for Reconstruction and Development, as well as the UN Security Council Sanctions Committee, towards the end of 1993, with a request for support in the implementation of this Programme, involving the unblocking of a part of the funds on Yugoslavia's accounts abroad, foreign financial support if possible and advice on and appraisal of the Programme itself from/by their experts. However, none of the proposed forms of cooperation were accepted because of the sanctions, and these institutions notified the Yugoslav Government accordingly."

[54] In the first few months of the programme implementation, the income tax was first reduced to 35 per cent, then to 30 per cent, and later to 25 per cent; sales tax was reduced from 46 per cent to 27 per cent, and excise duty introduced for six groups of products; corporate profit tax was reduced from 40 per cent to 30 per cent. Even the tax on financial transactions, which was retained for some time, was abolished on 19 April 1994. However, together with the reduction of tax burden on some fiscal forms, there was an introduction of a fee on owning a company (the so-called "company fee"), which had not been foreseen by the PMR.

In the first 85 days of its implementation, the programme produced goods results. Firstly, as shown in Graph 3.2, prices stabilised completely, with weekly changes of 0.1 per cent recorded after the commencement of the programme. Nevertheless, what can also be seen in the graph is that within the observed average of price fluctuation, considerable structural differences in the price fluctuation of agriculture products, industrial products, service and merchandise were recorded. Still, such a tendency existed only until mid-February 1994, after which the difference in the price increase dynamics in separate sectors was significantly reduced and, as of mid-February, was almost invariable.

Graph 3.2. *Price movements from 24 January to 18 April 1994*



Source: Avramović (1994, p. 28).

Secondly, the programme contributed greatly to an increase in foreign currency reserves in the period from its inception until the end of March 1994. By setting up an environment which resulted in recovered citizens' confidence in the new dinar, the programme enabled an autonomous flow of money supply to take place. Remonetisation happened through the unlimited purchase of foreign currency from households and businesses by commercial banks. Having in mind that the actual purchase of DEM 286 million exceeded by a factor of two the estimated amount of DEM 150 million, the action was seen as a success story.

Thirdly, according to Avramović (1994, p. 26), the PMR contributed to the "the quick renewal of state finances". The fiscal policy reform led to an increase in Serbia's public revenues, which was since March 1994 used to cover a portion of the projected budgetary deficit of 147 million new dinars per month. On a federal level, however, total public expenditures exceeded public revenues by 334 million new dinars: the amount that was financed directly form the NBY sources and backed by the foreign exchange reserves. Herein, the budgetary deficit of 334 million dinars in comparison to projected 229 million dinars was still considered attainable.

Following the increased scope of credit activity, primary issue and money supply, interest rates were reduced as well. The interest rates, according to Avramović (1994, p. 28), were positive in real terms for the first time in Yugoslavia after 50 years, and were reduced to 9-12 per cent. All these changes resulted in an output increase of 12.4 per cent in February 1994, i.e. over 22 per cent in May 1994.

Regrettably, the Avramović programme just as the Marković programme, only lasted about nine months. According to Dinkić (2000, p. 268), "breaking into the monetary system in October 1994 definitely collapsed Avramović's stabilisation programme". The registered price rise in November 1994 was 7 per cent, whereas in January 1995 reached 12.4 per cent. Moreover, in late March 1995 there was another 'horrific monetary attack',[55] after which governor Avramović proposed the implementation of the so-called "Programme II" in summer 1995.

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[55] This 'monetary attack' differed from the previous attacks by the means used. It was not based on the grey emission of dinars, but was conducted with the legal emission of dinars and credits that the Serbian government transfer to selected commercial banks. This money ended in hands of street dealers, which used it to buy and sell foreign currency at speculative exchange rates (see Dinkić, 2000, p. 272-83).

Programme II was supposed to handle (1) the closed and controlled market, which did not allow for healthy competition, and (2) the domination of inefficient socially-owned companies and their abuse. Import liberalisation and privatisation were, therefore, next on the agenda. According to Dinkić (2000, p. 285), the set also included appropriate stabilisation measures of monetary character, the most important of which were the establishment of the real dinar rate through devaluation, solving bank insolvency problems, and setting up a strict financial discipline regime.

These measures were basically the same as those originally incorporated in the PMR but which could not have been implemented during the first wave of stabilisation. In that sense, the new programme actually represented the continuation of a policy oriented towards a complete stabilisation of macroeconomic fundamentals, complex structural reforms and sustained economic growth. The programme was set forth in late November 1995. Generally speaking, the date also could have been a good political moment for the programme implementation, since the Dayton Peace Accord was signed and economic sanctions against the FRY were partly suspended[56].

However, only six months after its implementation was begun on 15 May 1996, Avramović was formally dismissed from the position of NBY governor. Soon thereafter, the price increases were again registered. In the period from the inception of Programme II until August 1996, prices went up by 56 per cent (Dinkić, 2000, p. 291). During that time, the black market exchange rate was only 3 per cent higher than the official one. And, the fact that wages were paid in accordance with the changes of the black market exchange rate did not mean much as the registered price rise was greater than the foreign currency exchange rate. Thus, in this period, real wages were actually reduced, even though in nominal terms they were increasing. Due to the overestimated value of domestic currency, imports were surmounting exports, thus increasing the trade balance deficit, which in the first seven months of 1996 amounted to USD 1 billion.

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[56] "UN Security Council has, by Resolution No. 1074 of 1 October 1996, revoked the embargo imposed on the FRY, while leaving it to the states [UN member states, auth. remark] to adopt bilateral measures by which they will bring documents imposing embargo cancellation in bilateral relations" (Bošnjak, 2002, p. 79).

In the following sub-period of 1995-1998, the FRY economy was characterised by a reduction in the production scope, import and export levels, and levels of investments and employment. According to Bošnjak (2002, p. 29), "participation of gross investments in fixed assets was reduced to about 14 per cent of GDP, and participation of goods export to about 21 per cent of GDP". GDP levels registered in 1998 made for only one half of its 1989 level, both in aggregate and *per capita* terms. The unemployment rate reached 25 per cent and was accompanied by the registration of 900,000 redundant workers. Structure of the economy was also very unfavourable, with the dominant participation of social, state and mixed sector of about 60 per cent, and private sector participation of only about 40 per cent in GDP formation.

As a result, the transformation of the state and social ownership remained high on the governments' agenda during the 1990s. Several attempts to establish the operating transformation rules were made during the decade. Building on the federal law on the transformation of socially-owned capital that was introduced in 1989 as part of the overall Marković economic programme, another federal law was passed in 1996.[57] However, these laws only gave limited results, as they become just a framework for actions taken on republican levels, which were conducted on the basis of separate republican privatisation laws.[58] In Serbia, the whole privatisation process was a voluntarily, one as enterprises could chose either to transform their ownership or to retain the existing one.[59]

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[57] Federal Law on Transfer and Disposition of Socially-Owned Capital [*Savezni zakon o prometu i raspolaganju društvenim kapitalom*] was adopted on 22 December 1989 (Official Gazette of the SFRY", No. 84/89). This law was amended on 10 August 1990 (Official Gazette of the SFRY, No. 46/90) and, eventually, replaced by the Law on the Basis of the Transformation of Socially-Owned Capital [*Zakon o osnovama promene vlasništva društvenog kapitala*] on 26 June 1996 (Official Gazette of the SFRY, No. 29/96).

[58] The Republic of Serbia adopted the Law on Conditions and the Procedure for Transformation of Social Ownership in Other Forms of Ownership [*Zakon o uslovima i postupku pretvaranja društvene svojine u druge oblike svojine*] (Official Gazette of the RS, No. 48/91) on 5 August 1991. This law was amended on 1 August 1994 (Official Gazette of the RS, No. 51/94), and finally replaced on 22 July 1997 by the Law on Ownership Transformation [*Zakon o svojinskoj transformaciji*] (Official Gazette of the RS, No. 32/97). On the other hand, Republic Montenegro adopted the Law on Ownership and Management Transformation in 1992 [*Zakon o svojinskoj i upravljačkoj transformaciji*] (Official Gazette of the RM, No. 2/92), which it replaced on 31 July 1996 by the Privatisation Law [*Zakon o privatizaciji privrede*] (Official Gazette of the RM, No. 23/96).

[59] The voluntary principle derives from the Serbian Constitution of 1990, which proclaims equality of all forms of property ownership. See Article 56 of the Constitution of the Republic of Serbia (Official Gazette of the RS, No. 1/90) published on 28 September 1990.

However, the state preserved its right to refuse to consent over certain enterprises' privatisation decisions if these were public or large social enterprises, making up 40 per cent and 30 per cent of the total capital, respectively. The remaining 30 per cent, i.e. small and medium firms, had the autonomy over transformation decisions, unless their debts exceed the capital or if they were under bankruptcy procedure. The model of voucher privatisation was applied, enabling each worker to purchase a small part of his enterprise. This way, the proclaimed government aim to ensure a fair privatisation was achieved, but whether this transformation brought the desired results in terms of firms' efficiency, and whether it contributed to the transition process, is another question.

3.3.2. Economic aspects of the Kosovo conflict and the NATO raids of 1999

If one considers that the period between 1992 and 1998 is marked by an extreme sluggishness of economic activities of the country, than, undoubtedly, the year 1999 should be referred to as a year of a total collapse of the country's economic performance. The causes for such occurrence lie in the fact that in 1999 the country was exposed to the most severe external shock which took place in Europe after the World War II; the three-month military campaign by the North Atlantic Treaty Organisation (NATO), due to which the year 1999 will be well remembered in the Serbian history:

> "Violating the provisions of Article 2 of the UN Charter, without the consent of the Security Council, 19 NATO member countries carried out the bombing of FRY. The air attacks lasted for 78 days without interruptions, from 24 March until 9 June 1999, and caused drastic negative and long-lasting effects to the economy and to the citizens" (Bošnjak, 2002, p. 98).

Notwithstanding the human cost of the war[60], all segments of economic and industrial life were directly affected. According to Dinkić (1999, p. 7) NATO's targets were not only military objects, but also Serbia's most important infrastructure constructions: roads, airports, telecommunication objects, hydro-electric power plants, chemical, petrochemical, oil and gas refineries, etc. Besides, some health, education, cultural, religious and housing objects were severely damaged as well.

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[60] "Some 500 Yugoslav civilians are known to have died in these incidents" (HRW, 2000, p. 1).

As a consequence, in 1999 the FRY registered an 18 per cent drop in GDP compared to the previous year, as well as a drastic decline in the exchange of goods with the world amounting to 36.5 per cent; exports were reduced by 46.9 per cent and imports by 30.4 per cent. Real net wages were reduced by approximately 15 per cent, and about 300,000 employees were dismissed, causing a 27.7 per cent *increase* in unemployment rate. It is estimated that the destruction of basic infrastructure in Serbia had also influenced regional distractions, as the neighbouring countries registered declines in foreign direct investments (Bulgaria), tourism income (Croatia), and export levels (Romania).[61] The region also experienced a raise in transportation costs for all those being forced to find alternative solutions for transport of goods and passengers, as suggested by anecdotal evidence.

The consequences of the NATO foray are twofold: direct and indirect. Besides the calculated, direct effects of NATO operations on real GDP loss, a potential GDP loss in the subsequent years, indirectly resulting from NATO bombing, should also be taken into account. While the negative real GDP growth of 18 percent in 1999 was the lowest GDP growth ever recorded, a further reduction of potential losses has depended on real opportunities to reconstruct all the destroyed industrial and production capacities of the country. Bošnjak (2002, p. 65) indicates that losses in terms of unrealised gross domestic product amount to USD 30.3 billion for the period 1999-2010. To this indicative estimation of loss, one should also add the costs of the renewal of damaged cultural-historic monuments, natural resources due to ecological contamination[62], etc.

The final accounts of the estimated costs of the NATO incursion are not uniform. This is due to the fact that estimators have applied different methodological approaches in defining the scope of the parameters considered to have made an impact on losses incurred and that they have assigned diverging indices to the selected parameters. Thus, the World Bank indicates that material damages in Kosovo amounted to USD 1.2 billion, whereas Dinkić (1999, p. 9) has estimated the total economic damage at USD 29.6 billion; the interim calculation of the Serbian Government made just after the bombing indicates that the damage amounts to USD 11.7 billion (Bošnjak, 2002, p. 66).

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[61] The mentioned countries reported to the UN Economic Commission for Europe in May 1999 the damage and costs resulting from the events that took place in the preceding months in the FRY.
[62] See Kurykin (2001)

3.3.3. The 'bulldozer revolution' and the year 2000

The Federal Republic of Yugoslavia entered the year 2000 with unfavourable macroeconomic indicators, but this period will undoubtedly be remembered by political changes that took place: the overthrow of Slobodan Milošević from power on 5 October 2000. In relation to this, Birch (2002, p. 499) writes the following:

> "The date of 5 October 2000 has become a by-word in Yugoslavia for the collapse of the old regime and the inauguration of a new order. Slobodan Milosevic was removed from power when a popular mob stormed the Yugoslav parliament building and the main television station, and the Federal Election Commission was obliged to admit what independent election-watchers had been claiming for days–that Milosevic had lost the 24 September contest for the presidency. The result of Yugoslav parliamentary elections held the same day was more mixed, with parties that had supported Milosevic retaining a majority of seats. Yet in the highly-personalised politics of Yugoslavia, the fact of Milosevic's removal from office brought about the end of an era. Following the dramatic events of October, premature elections were announced for the parliament of Serbia, which was at this point still controlled by Milosevic's Socialist Party. These polls, eventually held on 23 December 2000, were won by the Democratic Opposition of Serbia, whose leader Zoran Djindjic then became Prime Minister of the Serbian republic".

On the economic front, the situation called for the reconstruction of an exhausted economy and the continuation of transition. The economic revival was, however, burdened by an unfavourable macroeconomic situation. According to the EBRD (2003, p. 191), the year 2000 registered a percentage change in consumer prices (end-year) of 113.5 per cent, whereas GDP percentage change in real terms stood at 5 per cent. FRY's foreign trade, which declined drastically during 1999, in 2000 also registered a low level of exports and imports of USD 1.9 billion and USD 3.7 billion, respectively. Foreign currency reserves of NBY amounted to USD 524.2 million, whereas the total external debt of the country was USD 11.7 billion. Net foreign direct investments (FDI) equalled to USD 25 million, which was even lower then in 1989. Official unemployment as a percentage of total labour force was 28.4 per cent. Nominally, though, some of the macroeconomic parameters recovered compared to 1999, but having in mind their low starting base, the improvements were not substantial. Consequently, the macroeconomic results of 2000 were still very weak and the economy faced new political and constitutional challenges.

3.4. Serbia within the State Union (2001-2004): Transition Continued[63]

We recall from the previous sections that Serbia was a constituent republic of the FRY until 4 February 2003, when the Constitutional Charter of SCG was adopted. However, the changes that took place after 5 October 2000 were influenced far more by political factors than by the institutional framework of the country. Thus, this work – which investigates the economic rather than the legal aspects of the transition in Serbia – separates the analysis into two periods: (1) the period of Milošević ruling and the economic downfall (1992-2000), and (2) the period of continued transition and opening towards the world (2001-2004). Having in mind, though, that the complexity of the constitutional arrangement of SCG greatly influenced some of the economic actions in Serbia during this period, Box 3.1. provides a short overview of the main constitutional elements of SCG.

Most important for out study is the fact that from 2000 thereafter the general course of the development of Serbian society changed so significantly it that enabled the continuation of the transition process. The newly elected government of Zoran Djindjić[64] chose to pursue the model of fast track economic reform established by the 'fast reformers' (Czech Republic, Poland and Hungary). The broad transition front that was established encompassed changes in foreign affairs, financial relations, monetary and fiscal sphere, institutional and regulatory domain and many other fields. The wide political consensus, that held the ruling coalition together at the beginning of democratisation of the country in 2001 allowed for such dynamic approach to be taken.[65]

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[63] Throughout the section Serbia is analysed separately from Montenegro, which started defining its own economic entity from 1997 thereafter. Therefore, the term 'country', which for the purpose of this section and for the ease of reading refers to Serbia solely, is used in an economic and not in a constitutional sense describing the territory that has exclusive competencies in monetary, fiscal and customs areas.

[64] Dr Zoran Djindjić was the Prime Minister of the Government of the Republic of Serbia since 25 January 2001 until 12 March 2003, when he was assassinated in front of the government building. Djindjić was also one of the founders of Democratic Party (*Demokratska stranka*, DS) and its president from January 1994.

[65] The Democratic Opposition of Serbia (*Demokratska opozicija Srbije*, DOS), the ruling coalition led by DS included 17 other political partners. Apart from the Democratic Party of Serbia (*Demokratska stranka Srbije*, DSS), which was the second biggest coalition party, all other coalition parties were *de facto* minor DS's partners. The political unity was hampered already during 2002 as DSS led by Vojislav Koštunica, who was at the time the President of the FRY, step out of the government in August 2002. Koštunica became the Serbian Prime Minister on 3 March 2004 after the second round of post-Milošević democratic parliamentary elections held on 28 December 2003.

Unlike other sections which focus on different sub-periods, this section is divided into several sub-sections applying a thematic, rather then a time-based analysis. This approach allows for a cross-section examination of the most important transitional actions, which were conducted during the four-year period (2001-2004). These actions relate to the measures applied and the results achieved during the stabilisation period in the following three areas, which we considered the most relevant for our study:

(i) International and European relations

(ii) Macroeconomic developments

(iii) Monetary, exchange rate and banking sector reforms.

Box 3.1. *Selected constitutional features of the State Union SCG*

Common market

Article 12 paragraphs 1 and 2 of the Constitutional Charter of the State Union Serbia and Montenegro (hereafter: the Constitutional Charter) stipulates that the State Union has a common market, which unhindered functioning falls under the responsibility of the member states, i.e. Serbia and Montenegro.

International subjectivity

Article 14 paragraph 1 of the Constitutional Charter stipulates that SCG has the legal subjectivity and that it is a member of those international institutions, which require international subjectivity. However, the paragraph 2 of the same article envisages that the SCG member states can become the members of those international institutions, which do not require international subjectivity. This is, however, only possible if the prospective membership does not resume the responsibilities of the SCG and if it does not endanger the interests of another member state (Article 15 paragraph 2).

Representation of the State Union SCG

Article 34 paragraphs 1 and 2 of the Constitutional Charter prescribe that the member states are represented in the international organisations: UN, OSCE, EU and CoE on a rotating parity-based principle, but that the Council of Ministers of the State Union, with the consent of the responsible bodies of the member states, determines the ways of representation and presentation of the member states in the international financial organisations. Additionally, Article 14 paragraphs 1 and 4 of the Law on the Implementation of the Constitutional Charter of the State Union Serbia and Montenegro stipulate that the Council of Ministers of SCG, upon agreement with the ministries of finance and the central banks of the member states, decides upon the fiscal agent in the international financial organisations, whereas the function of the payment agent shall, on behalf of the member states, be performed by the National Bank of Serbia and the Central Bank of Montenegro.

State Union financing

Article 18 of the Constitutional Charter prescribes that the member states will ensure financial means needed for the State Union functioning. In other words, the Constitutional Charter did not envisage the State Union budget, but contributions by the member states.

Division of responsibilities

Art. 40 to 46 of the Constitutional Charter envisage the responsibilities of the following five ministers of the State Union: Minister of Foreign Affairs, Minister of Defence, Minister of International Economic Relations, Minister of Internal Economic Relations and Minister of Human and Minority Rights. All other affairs from the domain of economy, monetary, fiscal, financial and trade policy are exclusive competency of member states.

Source: Author, based on Fira and Bataveljić (2004).

3.4.1. International and European relations: a ' window of opportunity'

The democratic changes that followed the decade-long international isolation imposed on the country during the Milošević era, Belgrade was given a great degree of international political and financial assistance in the period 2001-2004. Soon after 5 October 2000, SCG intensified its international relations and in a legal sense gained or re-activated its membership within many important international organisations.[66] Opening up of the country in geo-political and economic terms also encompassed the strengthening of regional cooperation. SCG participated in various regional initiatives such as the Stability Pact of South East Europe (SP-SEE) and the Central European Initiative (CEI), as well as through preparations for eventual membership in the Partnership for Peace (PfP) and NATO.

This political support was backed by significant multilateral and bilateral foreign aid, pledged by numerous countries and international organisations during the Donors Conference held in June 2001 and on many other occasions.[67] This aid, either in the form of grants or loans, ensured that Serbia would step up the process of stabilisation and transformation and that it would pursue economic reforms. Equally encouraging for Serbia's economic development was reestablishment of relations with international financial institutions (IFIs) such as the International Monetary Fund (IMF), the World Bank (WB), the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD).

Most importantly, however, is that the interrupted political and economic ties between Serbia and the European Union began strengthening after 2000 onwards, under the cap of the Stabilisation and Association Process (SAP).

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[66] For example, Serbia-Montenegro became the member of the United Nations (UN) and of the Organization for Security and Co-operation in Europe (OSCE) in December 2000, and of the Council of Europe (CoE) in October 2002.

[67] The Donors Conference of June 2001 was an occasion where the Serbian government presented its reform agenda, which outlined the direction of planned reforms and which served as a basis for donors' decisions to pledge financial resources for particular reform projects. The reform agenda was presented in the document "Reform Agenda of Serbia" (Government of the Republic of Serbia, 2001). The subsequent Donors Meeting that was held in Brussels in November 2003, on the other hand, represented a coordination meeting where the Serbian government provided the donors' community with an update about the achieved reform results and its further reform plans. The core document presented during the second Donors Meeting in November 2003 was "Serbia on the Move: Three Years Later" (Government of the Republic of Serbia, 2003).

The stabilisation and association process, which normally precedes the conclusion of a Stabilisation and Association Agreement (SAA) with the EU, includes several important elements. Firstly, SAP assumes that a continuous political and technical dialogue is established between the representatives of the SAP country and the European Commission.[68] Such intense dialogue paves the way to work on the Feasibility Report prepared by the European Commission. Its main objective is to assess a SAP country's political and economic developments in relation to the Copenhagen political and economic accession criteria, and the administrative capacity of a country to negotiate, conclude and implement the SAA.

Aside from the political and technical support, in 2000 the EU unilaterally introduced trade preferences for goods imported from the Western Balkan countries, including Serbia and Montenegro.[69] These "autonomous trade measures" (ATMs) enabled the Western Balkan countries a duty free access to the EU market for almost all goods,[70] under the condition that the countries respect the rules of origin and the so-called 'standstill clause'. Compliance with the first condition assumes the ability of the authorities to adequately apply the system of certification and control of the preferential origin of goods exported to the EU, and to verify the originating status of those products. The standstill clause implies that a country benefiting from the ATMs should not introduce new or increasing existing duties, charges and quantitative restrictions or measures having the equivalent effect for imports originating in the EU.

Additionally, the overall process of European integration has been backed by substantial EU financial assistance, disbursed under the Community Assistance for Reconstruction, Development and Stabilisation (CARDS) programme managed by the European Agency for Reconstruction (EAR). Apart from CARDS, the EU's financial support also included emergency assistance, channelled through the European Community Humanitarian Office (ECHO) and Macro Financial Assistance (MFA), which provided support to the balance of payments adjustments (see Table 3.4).

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[68] The dialogue between the EU and SCG was held under the framework of the Consultative Task Force (CTF) and Enhanced Permanent Dialogue (EPD) meetings, held regularly every 3-4 months. SCG hosted five CTF meetings during 2001and 2002 and eight EPD meetings in the period 2003-2005.

[69] Council Regulation (2007/2000/EC), Official Journal of the European Communities, L 240, pp. 1-9.

[70] The only exceptions are exports of vine, baby beef, some fishery products, and textile (until 1 July 2005 when the Textile Agreement between the EU and Serbia entered into force).

Table 3.4. *EU assistance to Serbia (2000-2004)*[1]

EUR millions

SERBIA	2000	2001	2002	2003	2004	Total
CARDS						
Allocation	182	194	171	220	202	979
Committed/Allocated	100%	100%	93%	82%	40%	82%
Paid/Committed	100%	99%	84%	48%	10%	76%
ECHO						
Committed/Allocated	20.15	47.89	31.85	5.30	-	105.19
Disbursed	13.25	35.63	35.82	20.49	-	105.18
MFA[2]	-	345	130	70	70	615
	-	310.50	116.50	70	70	569
	-	234	103.50	47.20	117	501.70

Note: [1] Data without Kosovo and Metohija.
[2] Data includes Montenegro, which share equalled to 10 per cent (Serbia received 90 per cent).

Source: Official website of the European Agency for Reconstruction, www.ear.eu.int [Accessed: 14.03.2005] and the Ministry for International Economic Relations of the Republic of Serbia.

The above-mentioned examples of international assistance to Serbia in the period following the downfall of the Milošević regime point to the fact the Serbian government mounted a large political capital within and outside the country. This political capital was transposed into a level of credibility that (for a short and limited period of time) eased the reform process, as suggested by the argument of 'extraordinary politics' deriving from "a great change in a country's history" (Balcerowicz, 1993, p. 31)[71].

The Serbian experience of 2000 thus confirms that some other events beside the fall of communism can represent the perfect momentum for the implementation of an immense reform agenda.[72] Namely, owing to the enormous accumulation of common will to overthrow Milošević, Serbia's political opposition brought about huge changes in the political and economic system of the country of a magnitude comparable to the sudden fall of communism elsewhere. The introduction of those changes was possible because the elites of the former regime were at that time discouraged and disorganised, new interest groups were not yet formed, and the population was willing to accept changes.

[71] Wyplosz (2000, p. 9) interprets this 'political window of opportunity' more narrowly, assigning it to the exceptional political circumstances that followed the collapse of communism.
[72] One should bear in mind that the communism in Serbia collapsed well before 2000, in the late 1980s (see Birch, 2002).

It should be noted, however, that due to internal political instability and external political pressures resulting from a non-cooperation with the International Crime Tribunal for Yugoslavia (ICTY) in Hague, and the fact that on 12 March 2003 the Prime Minister Djindjic was assassinated, the political window of opportunity as seen by Balcerowicz (1993) was closed for Serbia.[73] The succeeding government of Prime Minister Zoran Živković,[74] which lasted until 3 March 2004, tried to reafirm the dynamics of reform and the course of the transition as established by the preceeding Djindjic's government. But, it *de facto* lost this 'battle'. Besides the fact that its was heavily attacked by the opposition throughout its short mandate, this government was also strongly pressured by the internation community with regards to furthering co-operation with the ICTY.

Nonetheless, the international community has tried several times during 2003 and 2004 to ensure that the country remained on a reform track. The EU itself had shown, on many occasions, its strategic interest in the prosperity and integration of the Western Balkans including Serbia and Montenegro. In political terms, in June 2003, the ministers of foreign affairs of the EU Member States concluded, during the first political EU-Western Balkans Summit held in Thessaloniki, that "the future of the Balkans is within the European Union".[75] Consequently, on 14 June 2004 the Council of the EU decided to adopt the "European Partnership"[76] as a new SAP instrument. The *European Partnership* was formulated in a way to guide the country's process of European integration. In particular, it included a set of short-term (to be implemented in 1-2 years) and medium-term (to be implemented in 3-4 years) political and economic priorities, which Serbia and Montenegro needed to realise on its way to the European Union.[77] These priorities, however, were not 'imposed' on the SCG by the EU, as they represented a sublimation of the *joint* conclusions and EU recommendations issued during the CTF/EPD meetings.

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[73] This assessment relates to the period 2003 and 2004 when, according to the ICTY representatives, Serbia-Montenegro was not collaborating with the ICTY sufficiently. On the other hand, during the same period the Serbian officials were trying to explain that the cooperation with the Hague does not only imply the extradition of indictees, as something on which the ICTY has persistently insisted, but that it also includes other legal actions with which the country was fully complying.

[74] Prime Minister Živković kept more or less the same cabinet as Zoran Djindjić.

[75] Conclusions of the EU-Western Balkans Summit.

[76] Council Decision (2004/520/EC), Official Journal of the European Union, L 227, pp. 21-34.

[77] These priorities relate to the activities in the following areas: democracy and rule of law, human rights and protection of minorities, regional and international co-operation/obligations, co-operation in justice and home affairs, establishment of market economy, structural reforms, management of public finances, internal market and trade, and sectoral policies (agriculture, transport, energy, environment, etc).

However, owing to the complex constitutional frame of the State Union and the lack of political will on the part of the Montenegrin government to build a strong and functional common administration, the fulfilment of certain priorities was completely stalled. The most obvious example was the inability of SCG to establish a common market which would allow for the free movement of goods, services, people and capital. Recognising the existence of separate, republic-exclusive competencies and the treaty-making powers of the two SCG constituent republics in most of economic and trade-related matters, the EU Member States foreign affairs ministers introduced the so-called *'twin-track approach'*. The twin-track approach was informally adopted in Maastricht on 3-4 September 2004 during the Gymnich meeting[78]. Formally, this approach was endorsed on 11 October 2004 by the Council that gave its support:

> "[...] for the twin-track approach, which would imply a single Stabilisation and Association Agreement with distinct negotiations with the Republics on trade, economic and possibly on other relevant sectoral policies. The Council reaffirmed its commitment to a strengthened State Union of Serbia and Montenegro based on the Constitutional Charter."

Following the introduction of the twin-track approach, the process of European integration for Serbia (and Montenegro) once more gained momentum. The work on the Feasibility Report for the State Union of Serbia and Montenegro by the European Commission, which resumed in October 2004, added a whole new dimension to the reform process in the country. The positive assessment of the readiness of the SCG to negotiate the SAA with the EU[79], which came out as a result of this process, reopened the window of opportunity for the country, helping it to re-establish its credibility, much needed for further economic reforms. More formally, a positive Feasibility Report enabled the European Commission to prepare its mandate for the SAA negotiations with the SCG and to actually begin those negotiations upon approval by the Council, in October 2005.

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[78] Gymnich stands for regular semi-annual informal meetings of the EU Member States Foreign Affairs Ministers named after the German city where such first meeting took place in 1974.
[79] See the European Commission document COM(2005)476 final and SEC (2005)248 final dated 12 April 2005.

3.4.2. Macroeconomic developments: the 'Balkan tiger' [80]

The fact that Serbia after October 2000 managed to articulate its political activities around the democratic principles for which it attracted strong international support also influenced its economic performance. The purpose of this sub-section is to provide an overview of the main macroeconomic achievements Serbia realised during its 3-year stabilisation period (2001-2003). Based on our findings from the previous chapter, we argue that initial inflation stabilisation ceased in 2003 when the inflation rate fell below 20 per cent – and in any case below 40 per cent per annum, as suggested by Bruno (1993) and Begg (1996), respectively.[81] The year 2004 only brought some minor structural reforms due to intensified political commotion, which in a way, agitated the already achieved macroeconomic stability, as will later be demonstrated in our thesis.

The stabilisation begun in 2001 was based on a well-structured government economic programme.[82] The applied stabilisation programme was an exchange rate-based programme, which included the unification of the exchange rate and an initial devaluation of the national currency. Also, the programme envisaged price and trade liberalisation and the resolution of the accumulated debt through its reduction and rescheduling. The crucial component of the programme, however, was the separation of fiscal and monetary policy and a clear discontinuity with the past policy of financing government deficits through money creation, and imposition of hard budget constraints.

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[80] 'Balkan tiger' is a phrase used by Mr Božidar Djelić, Minister of Finance and Economy of the Republic of Serbia in the period January 2001-March 2004, during his speech delivered at the Donors Meeting for SCG held in Brussels in November 2003. The phrase represents an allegory to the fast-developing Asian countries dubed 'Asian tigers', which describes one country's good macroeconomic results and a great underlining potential for further economic growth and development.

[81] See Chapter II of this work, page 20.

[82] The evolution of the government reform plan applied in 2001 is rather interesting. Namely, in 1997 the group of 17 independent experts named 'Group 17' or 'G17' wrote "The Programme of Radical Economic Reforms in the FR Yugoslavia" [*Program radikalnih ekonomskih reformi u SR Jugoslaviji*]. Later on, during 2000 the group of 20 authors led by Dragoslav Avramović and Pavle Petrović prepared the project "Recovery and Transition of the Yugoslav Economy" [*Oporavak i tranzicija jugoslovenske privrede*]. This voluminous study encompassed the three synthetic studies: (i) "The FRY Economy: the New Tendencies and the Main Imbalances" [*Privreda SRJ: Novije tendencije i glavne neravnoteže*], (ii) "Macroeconomic Stabilisation and Recovery of the Yugoslav Economy" [*Makroekonomska stabilizacija i oporavak jugoslovenske privrede*], and (iii) "Structural Economic Reforms" [*Strukturne ekonomske reforme*]. The second study that was written by Petrović, Arsić, Dragutinović and Stamenković, together with the mentioned G17's work (Group 17, 1997), made a basis for the government's stabilisation program in 2001.

It is peculiar that the Serbian stabilisation programme was not drafted by the IMF, as it has in many other East European transition countries. The Fund, as well as other major international partners (e.g. World Bank), however, had an important advisory role in fine-tuning of the existing government programme in cooperation with the authorities. Also, the IMF officially backed that programme on 11 June 2001 by approving (to the FRY) an amount of SDR 200 million under the Stand-by Arrangement, and SDR 650 million on 14 May 2002 under the Extended Fund Facility.[83] According to Begg (1996), such IMF role in transition is bilateral rather then systemic, as it focuses on technical advising in construction of a programme's details and in its overall preservation.

It is also interesting to note that Serbia's 2001 stabilisation did not *per se* differ much from the reform programmes previously applied in FRY and in SFRY that we presented in the previous sections. What was different, however, was the political support to stabilisation and reforms. Group 17 (1997, p. 31) notices that an already implicit and weak political support to earlier stabilisation programmes in Serbia tended to fed out only after 4-6 months of implementation, confirming the thesis that the problem was in the political oligarchy and not in the economic reform design.[84]

Therefore, one could argue that the Balcerowicz's (1993) 'extraordinary politics' argument has played in Serbia from 2000 onwards an even more important role than in some other transition countries. The conclusion is that success on the economic front was only possible after a new government was put in place and obtained the largest possible political support, as that was the case with the democratic government of Dr Zoran Djindjić in 2001. Moreover, Serbia's case confirms that the beginning of stabilisation goes in hand with international support, and that it coincides with IMF financing, as suggested by Fisher, Sahay and Végh (1996, p. 5). The results of such approach are presented in the following pages.

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[83] At 20 December 2000 the IMF determined that the FRY has fulfilled the necessary conditions to succeed to the membership of SFRY with the overall quota amounting to SDR 467.7 million (about USD 604 million). On the same day, the IMF Executive Board also approved a loan to FRY in equivalent of SDR 116.9 million (about USD 151 million) under the *Emergency Post-Conflict Assistance*. Of this amount, about USD 130 million was used to bridge the loans that were received to eliminate arrears with the IMF.

[84] One should, however, note that the observed period (2001-2004) was also politically turbulent in a sense that the three different governments and three central bank governors were in charge of implementation of that programme at different sub-periods. Nevertheless, the same course of actions was more or less preserved over the period; the only exception being the year 2004 with regards to privatisation.

- **Price and trade liberalisation**

Price liberalisation in Serbia was carried out in October 2000 when price controls on most goods were abandoned or relaxed, and disparities eliminated.[85] According to Bošnjak (2002, p. 124), even though this initial price liberalisation induced a one-off price increase of 26 per cent in October and of 19 per cent in November 2000, it eliminated the existing shortages, especially of some foodstuff. Still, price controls for some medicines, electricity, public services, food, oil and oil derivatives remained. Their share in the retail price inflation basket in 2004 accounted for 40 per cent (IMF, 2005, p. 69) although initially the reform plan envisaged their gradual adjustment over a period of three years so as to smoothen their negative impact on a low standard of living.

In order to allow international competition to affect domestic prices and to reinforce price liberalisation, *trade liberalisation* was initiated in December 2000 based on the amended Foreign Trade Law[86]. The foreign trade regime in general was also largely liberalised in May 2001, when most non-tariff import restrictions (import licences and quotas) were abolished and a new Customs Tariff Law[87] was introduced on a federal level. Those measures resulted in the reduction of the average weighted tariff protection rate in Serbia from 14.43 per cent to 9.37 per cent. The total reduction of the overall protection level is difficult to determine due to existence of discretionary system of import quota/licence allocation of the previous foreign trade regime.

Although there exists a solid theoretical background to support the parallel elimination of import licences and quotas, there is also an argument suggesting that the tariff level should not be reduced to a very low level, or to zero, at once (Bruno, 1993) Namely, time is needed for the economy in transition to restructure and to resume growth, which implies that a gradual approach to trade liberalisation should be taken. It is nevertheless difficult to determine the right speed and the level of trade liberalisation. In our view, though, the initial reduction of the overall tariff level by about one third that was applied in Serbia in 2001 was, in fact, outsized.

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[85] This initial price liberalisation was carried out by the leaving government aiming at producing political instability, but this turned out to be an important reform step. See Bošnjak (2002) and Arsić *et al.* (2001).
[86] Official Gazette of the FRY, No. 73/00.
[87] Official Gazette of the FRY, No. 23/01 and 40/01. This law applied to Serbia only.

The argument becomes even more compelling once the other trade liberalisation measures are considered. Besides the fact that Serbia phased out most of its non-tariff barriers on exports and liberalised crude oil imports in May 2003, it also further decreased its tariff protection in an attempt to harmonise its trade regime with that of Montenegro. The so-called Internal Market Action Plan[88] attempted to create a *common market* between Serbia and Montenegro, as envisaged by the Article 12 of the Constitutional Charter (see Box 3.1). The result was the harmonisation of 93 per cent of all tariff rates between the two republics, which further reduced the average weighted tariff protection rate in Serbia from 9.37 to 6.3 per cent (the nominal average rate stood at 7.37 per cent) as of 15 August 2003. Thus, within just two years, the tariff protection rate in Serbia was more then halved, as it was reduced by 56.34 per cent from 2001 to 2003.

It should also be mentioned that, within the SP-SEE framework, SCG signed and ratified a number of free trade arrangements with the regional countries during 2003 and 2004, further liberalising regional trade. The Memorandum of Understanding on Trade Liberalisation and Facilitation signed by Albania, Bosnia-Herzegovina, Bulgaria, Croatia, FRY Macedonia, Moldova, SCG and Romania called for the liberalisation of at least 90 per cent of all tariff lines, and 90 per cent of the value of bilateral imports.

However, Serbia kept some export controls on agricultural products as well as some import licences for steel products. Having in mind, though, that on 15 February 2005 Serbia (and Montenegro) separately applied for World Trade Organisation (WTO) membership[89], one can expect that further trade concessions will be made by Serbia over the medium-term. Such rapid trade liberalisation is not negative in itself, but it can pose a threat if not accompanied by more sophisticated methods of protection of domestic industry such as, for example, countervailing, safeguard and anti-dumping measures, or higher technical standards.

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[88] The Law on the Action Plan of Harmonisation of the Economic Systems between Serbia and Montenegro to Prevent and Remove Barriers to Free Movement of People, Goods, Services and Capital (Official Gazette of the RS, No. 67/03). Even though 93 per cent of the tariff lines between Serbia and Montenegro have been harmonised, the formation of a single external commercial policy was never achieved. The reason why is this so, besides the lack of political will, is that Serbia and Montenegro have had opposing economic interests; Serbia wished to protect the domestic industry and agricultural producers, while Montenegro, being a small and open economy, aimed at protecting their consumers and importers.

[89] The Article XII(1) of the Agreement Establishing the WTO foresees the membership of "any state or separate customs territory possessing full autonomy in the conduct of its external commercial relations".

- **The balance of payment situation**

Hurried trade liberalisation and an inadequately balanced protection of domestic production, which in some cases resulted in a negatively effective protection rate[90], caused an ever-growing *trade deficit*. In fact, the trade deficit rose from EUR 1.74 billion in 2000 to EUR 5.9 billion in 2004 (33.7 per cent of GDP in 2004). Such a large trade deficit is, together with the current account deficit, considered as the most problematic macroeconomic imbalance of the Serbian economy in the observed period.[91] The trade deficit came as a result of large imports that increased from EUR 3.3 billion in 2000 to EUR 8.94 billion in 2004, accounting for 43 per cent of GDP in 2004. On the other hand, the exports grew at a slower pace, from EUR 1.56 billion in 2000 to EUR 2.98 billion in 2004, which share in GDP in 2004 was 18 per cent.

Most of the imports in this period were driven by the Serbian companies' need to renew its machinery, public need for oil, and the citizens' need for quality (imported) goods for final consumption. The larger part of exports was on the side of raw or low-processed materials and agricultural products. Consequently, the structure of trade flows convectively point to a rising domestic demand and to a low level of competitiveness of domestic goods and services. Both of these indicators, in turn, point to the underlining structural problems of the Serbian economy, which can only be resolved by economic restructuring and underpinned by investments.

The macroeconometric modelling of the Serbian economy conducted by a group of Serbia's leading economists[92] point to the fact that the movements of the real exchange rate, real wages and industrial production predominantly determine the size of imports. According to Arsić *et al.* (2005, p. 214), real exchange rate appreciation leads to an import rise, as does the growth of real net wages that represents an indicator of domestic demand increase. Additionally, the authors show that an increase in industrial production is directly correlated with growing imports, mostly reflecting the import-oriented nature of Serbian production.

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[90] Negative effective protection rate appears when the protection of final products is lower then the protection of inputs used in their production.
[91] See Arsić *et al.* (2005, p. 209).
[92] *Ibid.*

Regarding the current account as a whole, it should be noted that a partial *current account liberalisation* was already introduced in January 2001, whereas full convertibility for current transactions was adopted on 14 May 2002 in line with Article VIII, Sections 2, 3, and 4 of the IMF Statute. The Law on Foreign Exchange Transactions[93] that introduced the convertibility in current transactions, however, preserved controls on capital flows both for residents and non-residents throughout the observed period, and was, thus, deemed over-restrictive.

The large trade deficit was offset mainly by private remittances, accounting for 16.9 per cent of GDP in 2004, by the large inflow of official financing from IFIs, the EU and other donors,[94] by private capital inflows in the form of foreign direct investments (FDI), and to some extent by green-field investments. The stock of FDI inflows to Serbia in the period from 2001 and 2004 amounted to EUR 2.7 billion, placing Serbia behind only Croatia (EUR 4.7 billion) in terms of the highest FDI inflows among the Western Balkan countries. The inflow of FDIs was especially high in 2003 as a result of several successful privatisation deals and equalled to EUR 1.2 billion, or 4 per cent of GDP. Still, however, the estimated level of FDI inflows needs to ensure sustainable growth in Serbia in the forthcoming period.

The balance of payment statistics also reveals a large increase in the *official foreign exchange reserves* of Serbia. Total foreign exchange reserves increased from USD 890 million in 2000 to USD 5.1 billion in 2004. A substantial part of this increase was channelled through the remonetisation[95] of the economy, i.e. through a raise of foreign exchange bank deposits previously held outside of the banking system. Even though a certain percentage of this remonetisation happened automatically in the period preceding the replacement of the deutsche mark by the euro (first half of 2002), the process itself also reflected an increased confidence of the population in the macroeconomic stability and the domestic banking system of the country.

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[93] Official Gazette of the RS, No. 23/02 and 34/02.
[94] "Disbursements of donor support jumped from about US$ 210 million (2.3 percent of GDP) in 2000 to and average of US$ 756 million (5 percent of GDP) over 2001-2003" (World Bank, 2004, p. 7).
[95] Based on Arsić *et al.* (2005, p. 145), we define monetisation as an effect of currency substitution in a situation when the foreign currency tends to replace domestic currency due to, for example, high inflation. Accordingly, remonetisation occurs when there is a growing demand for domestic currency (in real terms).

Regarding *debt reduction and rescheduling*, it should be noted that Serbia started repaying its debts again in 2001 after an almost eight-year of moratorium. The most important agreement was reached with Paris Club creditors in November 2001. This included the following two components: (1) a phased debt relief of 66 per cent of the net present value of commercial obligations equalling to some EUR 5.1 billion by end-2001, and (2) the rescheduling of the remaining stock over a twenty-two years, with a 6-year grace period.[96] Additionally, an arrangement was made with the London Club of commercial creditors in July 2004 that stated: (1) the write-off of almost 62 per cent of the net present value of EUR 2.2 billion (USD 2.7 billion) of outstanding debt, and (2) the rescheduling of the rest of the debt over twenty years, with a 3.75 per cent interest rate in the first 5 years, and a 6.75 per cent for the remaining fifteen years.

Moreover, Serbia has cleared all of its outstanding arrears with IFIs, and has concluded debt-rescheduling agreements with many other bilateral creditors. As a result of those efforts, Serbia was – for the first time in its history – granted a credit rating (in October 2004).[97] Despite these encouraging results, however, a high level of total external debt, which share in GDP stood at 63.6 per cent in 2004, placed Serbia among medium indebted countries according to World Bank criteria. Moreover, Serbia's medium- and long-term debt sustainability remains questionable, because of envisaged rising debt service obligations and it financing needs for restructuring and investments.

- **Fiscal adjustment and tax reform**

The effects of fiscal policy are somewhat less easily assessed due to the fact that fiscal measures take more time to transmit in the real economy. Nevertheless, one preliminary assessment made by the IMF (2004, p. 16) is that all throughout the observed period, the Serbian authorities managed to keep fiscal policy appropriately tightened, "albeit overly reliant on revenue measures".[98]

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[96] See World Bank (2004, p. 7).
[97] Serbian credit rating was established by Standard&Poor's and it stood at B+ (stable).
[98] The exception was the year 2003, when the fiscal policy turned out to be expansionary in the run-up to the general parliamentary elections held on 28 December 2003.

Besides fiscal tightening, one of the most immediate tasks in 2001 was to secure fiscal consolidation. Even though off-budget items and commitments were included into a consolidated budget, the budget deficit amounted to only 1.4 percent of GDP in 2001. A medium-term management on public revenues and expenditures was introduced through a three-year memorandum on economic and budgetary planning, as suggested by Bruno (1993, p. 233). Simultaneously, starting in March and April 2001, Serbia enacted a set of new tax laws incorporating significant tax reforms. A unified sales tax rate was introduced in 2001, replacing a number of different tax forms. The new system was based on the principle of efficiency, fairness and transparency. As a result, the new tax system become simplified, easier to administer, and rules-driven.

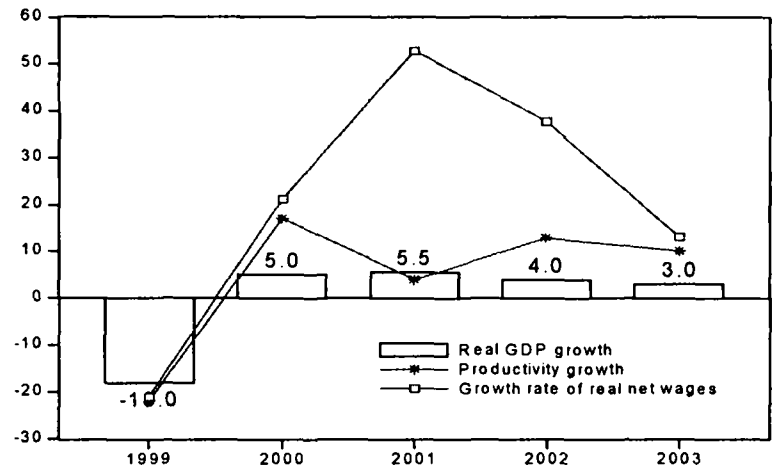
Furthermore, a comprehensive reform agenda for strengthening the tax and customs administrations responsible for revenue collection was designed. The new law on the budget system, tax procedures and tax administration, and the new customs law were enacted, and a new treasury system was introduced. The former payment bureau (*Zavod za obračun i plaćanja – ZOP*) was replaced by a new payment system. The fight against tax evasion started with the mandatory introduction of fiscal registries and so the share of the grey economy in the GDP started diminishing. The most evident result was an improvement in tax collection: this was reflected in a sharp rise in real government revenues from 39.1 per cent of GDP in 2001 to 45.8 per cent of GDP in 2004. Following the replacement of the sales tax with the value added tax on 1 January 2005, tax evasion was reduced and tax collection further improved.

However, having in mind that the move from a direct to an indirect taxation system has only been gradual and limited, there is still room for additional improvements. Also, the expenditure side of the budget has not been reformed enough and thus the expenditures rose to 45.8 per cent of GDP in 2004, comparing to 40.1 per cent of GDP in 2001. Even though there was a shift form current to investment spending, a large percentage of public spending requires further reform. Only in 2004, the budgetary adjustment reflected substantial cuts in overall spending, primarily through a reduction of transfers to the State Union and to state subsidies. These efforts, however, did not include major adjustments in current spending (wages and pensions). During 2001-2004, budget deficits were mainly covered by foreign financing and privatisation receipts.

- **Labour market and wage dynamics**

Similarly to other former-Yugoslav, and other transitional countries, Serbia experienced a strong real wage growth, once the transition continued in 2001. The actual results reveal average net monthly wage growth from about EUR 60 in early 2001 to approximately EUR 180 in early 2004, reflecting the real wage growth and real appreciation of the dinar (World Bank, 2004, p. 100). Such a considerable wage growth exceeded real GDP and productivity growth, as illustrated by Figure 3.1, thereby raising concerns over the Serbian competitiveness, ability to attract new FDIs and, therefore, over the entire sustainability of macroeconomic stability.

Figure 3.1. *GDP, productivity and wages in Serbia (1999-2003)*



Source: World Bank (2004, p. 101).

On the other hand, the unemployment rate increased more moderately, from 12.1 percent in 2000 to 18.5 per cent in 2004 (see Table 3.6), which is relatively low in comparison to other transition economies. Throughout the period, the labour market exhibited duality in many aspects, the most remarkable being a split between the formal and informal sectors. Herein, the formal labour market appears to be quite rigid, whereas the informal labour market, comprising around one-third of total employment, shows greater flexibility. Similar duality is observed between the private and state sectors, the former being more flexible, and the later relatively rigid. On average, according to the World Bank (2004, p. 102), labour mobility in Serbia befalls high, as 9 per cent of workers happen to change jobs within a given year.

- **Economic performance**

As shown in Table 3.6, real GDP grew on average by some 4.3 per cent annually from 2000 to 2003 – after a large drop of 18 per cent registered in 1999. During that period, industrial production was weak, and GDP growth was mainly driven by services (construction) and trade. Agricultural production was negatively affected by droughts in 2000 and 2003, resulting in an 12.4 and 7 per cent decline, respectively. Consequently, the share of agricultural production in GDP shrunk that year as well. Real GDP grew by 2.4 per cent in 2003, and thus mainly reflected buoyant services. During 2004, the situation was somewhat different, as real GDP growth reached 8.6 per cent as a result of a rebound in agricultural production and a recovery in industrial output, which followed major privatisation and the large inflow of FDI in the previous year (2003). During 2004, industrial output increased by 7.1 per cent compared to the same period in 2003. As a result of all these programmes and financial support, Serbia recorded the following macroeconomic results (see Table 3.6).

Table 3.6. *Main macroeconomic indicators, Serbia (2000-2004)*

INDICATOR		2000	2001	2002	2003	2004	I-VI 2005
Inflation	%	113.5	40	14.8	7.8	13.7	8.0
Real GDP growth	%	5.2	5.1	4.5	2.4	8.6	...
Productivity	Chain indices	116.9	104.1	112.7	110.9	112.5	104.9
Industrial production	Chain indices	114.4	100.1	101.8	97.0	107.1	97.9
Agricultural production	Chain indices	87.2	118.6	96.6	92.8	119.5	...
Unemployment (LSF data)	% of labour force	12.1	12.2	13.3	14.6	18.5	...
Net FDI	EUR million	54.7	184.1	504.8	1,203.4	777.1	563.7
Exports	EUR million	1,680.0	1,896.0	2,192.0	2,442.4	2,831.6	1,667.7
Imports	EUR million	3,606.4	4,757.9	5,918.6	6,589.3	8,623.3	3,614
Trade deficit	% of GDP	20.5	24.2	24.6	24.5	32.6	
	EUR million	1,926.4	2,861.9	3,726.6	4,146.9	5,791.7	1,946.3
CA deficit	% of GDP	3.8	3.3	10.0	9.2	13.2	
	EUR million	353.1	394.9	1,524.0	1,554.7	2,350.7	410.5
External debt	% of GDP	124.0	106.4	70.9	64.2	58.3	59.0
	EUR million	11,659	12,609	10,768.1	10,857.4	10,354.7	...

Note: LSF – Labour Force Survey, CA – Current account.

Source: Serbian Statistical Bureaux and the National Bank of Serbia.

3.4.3. Monetary, exchange rate and banking sector reforms

In the implementation of the stabilisation programme, which began in October 2000, one can distinguish between two sub-periods. According to Arsić *et al.* (2005, p. 127), the first sub-period that lasted from October 2000 to end-2002, and was characterised by fast disinflation, strong remonetisation, substantial appreciation of the real exchange rate, and a considerable rise in real wages. The same authors note that the second sub-period, which lasted from end-2002 to end-2004 registered sluggish disinflation, stagnation of remonetisation, moderate real exchange rate depreciation, and the slower growth of real wages. The purpose of this section is to reveal what factors influenced such processes and what results derived from them.

- **Exchange rate policy**

Due to the quite long and turbulent historical episodes of high (hyper)inflation, as described in the previous sections, an immediate task put before the authorities in 2000 was to establish the basis for the long-term stability of exchange rate and prices. The applied stabilisation programme was an exchange rate-based programme, in which the exchange rate was used as a nominal anchor.

The primary programme phase related to the unification of Serbia's multiple exchange rate system: official, commercial and grey market exchange rates all existed up until the last quarter of 2000. In the first instance, the programme envisaged a depreciation of the national currency's commercial exchange rate of to the level prevailing on the black market, i.e. from around YUD 20 to YUD 30 per DEM on 13 October 2000. In the second phase of the programme, on 5 December 2000, the official exchange rate of YUD 6 per DEM was abolished. On 1 January 2001, Serbia officially adopted a managed float exchange rate regime that, generally speaking, contributed to the increase of exchange rate stability. This move was largely in line with the policy recommendations, presented in Chapter II.

Nevertheless, the 'managed float' regime in Serbia was implemented in a rather restrictive manner, with the central bank intervening on the foreign exchange market in order to keep fluctuations of the exchange rate within certain narrow limits. Even though Bofinger and Wollmershaeuser (2000) note that this was a usual practice in many Eastern European transitional countries, which officially applied either a 'managed float' or 'independent float' exchange rate regime, such a policy was not without risks. Namely, having in mind that a large share of the loans in Serbia were extended under the foreign exchange clause, the impression created by the central bank that it was targeting the exchange rate may have cause some market participants to miscalculate their credit costs.

In nominal terms, the exchange rate of the dinar to the euro remained almost unchanged during 2001 and 2002. On the other hand, the real effective exchange rate increased by 16.8 per cent in 2002 only, which implied a real appreciation of the dinar by around 95 per cent in the period from October 2000 to end-2002.[99] According to Arsić *et al.* (2005, p. 124), such a substantial appreciation of the real exchange rate is characteristic for all transitional economies because of price liberalisation and the elimination of price disparities. However, the same authors point to the fact that in Serbia, two other country-specific factors were in motion. First, Serbia began stabilisation with an overly undervalued dinar exchange rate. Second, Serbia's exchange rate policy in the period until beginning of 2003 implied a *de facto* fixed nominal dinar exchange rate due to the 'fear of floating' (see Calvo and Reinhart, p. 2002).

Since the beginning of 2003, the authorities adopted a more flexible exchange rate policy even though officially they retained a 'managed float' regime. As a result, the dinar nominally depreciated by 11.1 per cent *vis-à-vis* the euro in 2003 and by 15.8 per cent in 2004. In real effective terms, the exchange rate remained broadly stable in 2003 and 2004, in line with announced policy objectives. This was due to the fact that the nominal effective rate depreciated faster then the difference between domestic and euro inflation. Furthermore, the period from 2003 to 2004 was characterised by slower remonetisation, that is, by slower growth of demand for domestic money, to which a slower increase in real wages also contributed.

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[99] See Arsić *et al.* (2005, p. 127).

- **Inflation**

Despite the successive adjustments of administered prices such as those for food and electricity, *inflation* in Serbia decreased considerably from 113.5 per cent in 2000 to 40 per cent in 2001. The rate of inflation in 2002 was then further reduced to 14.8 per cent annually as a result of cuts in government spending and improvements in foreign exchange inflows. In 2003, inflation was additionally lowered to 8 per cent, but had increased again to 13.7 per cent in 2004 in view of higher world oil prices, relatively strong wage growth, and dinar depreciation.

Still, compared to the dynamics of disinflation exhibited in other transitional countries, as presented by Cottarelli and Doyle (1999), the conclusion emerges that Serbia was very successful in achieving inflation stabilisation within a short period.[100] The question, however, remains as to whether Serbia should have disinflated at a slower pace, thus, reducing the risk of inflation reversals and the costs of real dinar appreciation.

We recall from previous sections that there is evidence to support the view that disinflation in transition contributes to a widening of external accounts.[101] Matching that with the disappointing results of a wide and ever-growing current account deficit in Serbia in the stabilisation period, we conclude that the country could have lowered the costs of rapid inflation reduction if it had disinflated at a slower pace, leaving the economy some additional time to restructure and gain on its external competitiveness. The econometric study of Arsić *et al.* (2005) also shows that a more substantial real depreciation of the dinar exchange rate during 2001-2002 would have led to the narrowing of external imbalances.[102]

Moreover, the likelihood of inflation reversals experienced by many transitional countries would have been significantly lowered.[103] Instead, Serbia faced an inflation turnaround already in 2004, when the actual inflation rate of 13.7 per cent exceeded the projected level by about 50 per cent.

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[100] The same conclusion appear if one confronts the Serbia's inflation performance against the more rigid criteria established by Easterly (1996) or Bruno (1993), as indicated on page 20 of this work.
[101] See page 40 of this work.
[102] As this did not happened, the current account deficit in Serbia reached a record high level of 13 per cent of GDP in 2004 (USD 7.5 billion), comparing to a far modest 0-5 per cent range in which the external account deficits of other transition countries orbited during the years of stabilisation. *Ibid.*
[103] See Cottarelli and Doyle (1999, p. 4).

By disinflating from a high above-one-hundred inflation rate to a one-digit one so quickly, the central monetary authority in Serbia imposed on itself an additional constraint; that is, an obligation to keep the rate of inflation at a 'historically' low level in the post-stabilisation years. That way, the NBS also eliminated the possibility of employing a surprise inflation in order to get a somewhat higher output growth, as some other transitional countries had done.

The conclusion that Serbia brought inflation down to a single digit rate too rapidly, within just 3-4 years of stabilisation, is also overwhelmingly supported by the findings of the interviews that were conducted during our research. The main argument is that such rapid disinflation, combined with the real appreciation of the dinar exchange rate, is not sustainable in the long-run. A second conclusion states that the central bank cannot successfully target both inflation and exchange rate. The proposition emerges to introduce an inflation targeting monetary regime, and to leave the exchange rate to be determined on foreign exchange market. In that, the targeted rate of inflation can be achieved by controlling other factors that encourage retail price growth, such as salaries and public spending.

- **Monetary aggregates**

Throughout the stabilisation period, the National Bank of Serbia pursued a (moderately) restrictive monetary policy. The basic monetary indicators are given in Table 3.7. The NBS money supply, i.e. the *primary issue*, increased from CSD 19,845 million in December 2000 to CSD 76,970 million in December 2004, that is, by 74 per cent in nominal terms. In real terms, the growth was negative, given the corresponding inflation rate. Higher net foreign assets (NFA) were the main primary issue maker in this period. On the other hand, net domestic assets (NDA) caused a reduction in the primary issue. The NDA decreased as a result of a drop in the state's net position at the NBS and of the other net assets. The rate of growth in the NFA and NDA of the NBS were, in fact, set as monetary policy quantitative targets together with the level of government borrowing from the banking sector.

The *money supply in the banking sector*, as measured by M1 monetary aggregate (currency in circulation and sight deposits), increased significantly from CSD 27,051 million in 2000 to CSD 111,179 million in 2004, that is, by approximately four times. It should be noted, though, that the highest growth was registered from 2000 to 2002, while during the years 2003 and 2004, M1 grew only moderately. According to the NBS (2003, p. 31), the high growth of M1 had no unfavourable effects on inflation in the 2000-2002 period, "since most money creation came from foreign currency transactions". At certain times, the M1 monetary aggregate did not grow as much as the primary issue because the monetary multiplier was lower because of the high mandatory reserve rate.

Table 3.7. *Basic monetary indicators, Serbia (2000-2004)*

in CSD million, end-of-period balance

Basic monetary indicators	2000	2001	2002	2003	20004
	Dec.	Dec.	Dec.	Dec.	Dec.
Cash	10,933	25,324	43,719	42,979	45,138
Bank reserves	8,912	16,155	25,605	27,017	31,832
Primary issue	**19,845**	**41,479**	**69,324**	**69,996**	**76,970**
Cash	10,833	25,266	43,719	42,979	45,138
CSD sight deposits	16,118	33,021	50,277	62,233	66,041
M1 monetary aggregate	**27,051**	**58,287**	**93,996**	**105,212**	**111,179**
M2 monetary aggregate	**32,995**	**68,204**	**111,161**	**124,824**	**146,613**
M3 monetary aggregate	**65,202**	**125,805**	**186,966**	**244,811**	**323,572**
CSD loans to the state	2,681	3,306	2,184	2,675	8,817
CSD loans to the commercial sector	186,908	206,991	134,822	141,605	202,780
CSD loans to the population	2,684	5,008	16,021	28,439	64,612
CSD loans to other sectors	22,593	29,229	5,146	3,399	4,055
Dinar investments of the banking sector	**214,866**	**244,534**	**158,173**	**176,118**	**280,264**
NBS hard currency reserves (USD mil.)	**524**	**1,169**	**2,280**	**3,550**	**4,244**
Total hard currency reserves (USD mil.)	**890**	**1,809**	**3,063**	**4,436**	**5,146**

Source: National Bank of Serbia, various issues.

Throughout the observed period, however, the structure of the M1 monetary aggregate remained unchanged, with the share of cash of about 40 per cent and the share of deposit money (dinar sight deposits) of around 60 per cent.

As a consequence of growth in the money supply M1, the money supply M2 (including total dinar deposits) as well as the money supply M3 (total dinar and foreign currency deposits) increased by about the same percentage as the M1 monetary aggregate. It is, however, evident from the data presented in Table 3.7, that the pace of growth of M1, M2 and M3 monetary aggregates was proportionally higher in the first two years of stabilisation (2000-2002) then during 2002-2004. Unlike the structure of money supply M1, the structure of the monetary aggregates M2 and M3 has changed over the observed period. In particular, the dinar term deposits were the main generator of the M2 supply growth, whereas the aggregate M3 changed due to increase in both the volume of dinar time deposits and foreign currency deposits. The foreign currency deposits mostly came from the 'new' citizens' foreign currency savings.

The 'new' citizens' foreign currency deposits are savings deposited at banks after 1 July 2001, which became subject to a 50 per cent liquidity requirement. The so-called 'old' or 'frozen' foreign currency households' deposits, which the state apparatus ceased repaying in early 1990, were not calculated against the reserve requirements. The FRY government only started gradually settling off its public debt based on the 'old savings' in 2001 in line with the provisions of the Law on the Settlement of Obligations Arising From the Foreign Currency Savings of Households[104] and the accompanying by-laws. In mid-2002 this law was replaced by the Law on the Settlement of Public Debt of the FRY Arising From the Foreign Currency Savings of Households[105], which fully transferred the public debt to the Serbian and Montenegrin republican budgets (see NBS, 2003). In order to meet its obligations arising from frozen deposits, the Republic of Serbia started the process of conversion of frozen deposits into euro-denominated bonds (securitisation), "with coupons at below market interest rates" (IMF, 2005, p. 68) on 31 August 2002.

Reserve money, which includes dinar reserve money (currency in circulation and commercial bank reserves) and bank foreign currency deposits over the stabilisation period (2001-2004) rose considerably because of an increase in both its components. A more significant increase, however, was registered in bank forex deposits with the NBS.

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[104] Official Gazette of the FRY, No. 59/98, 44/99, 30/00 and 53/01.
[105] Official Gazette of the FRY, No. 36/02.

At the beginning of stabilisation, changes in the structure of NFA inflows implied a portfolio shift from foreign currencies into dinars due to an increased in confidence of domestic currency. However, this trend reversed in 2003 and 2004, which points to the fact that this confidence might have fallen again as a result of inflation reversal and still large interest rates, thereby suggesting a monetary policy shift.

- **Monetary policy instruments**

During the first years of the implementation of the stabilisation programme, the NBS had a very limited range of monetary policy instruments at its disposal (IMF, 2002, p. 15). Still, this period witnessed the gradual evolution from direct to indirect monetary policy instruments, as well as the building up of the capacities and knowledge of the NBS's employees in the application of indirect monetary instruments. The main focus of the NBS was to absorb the excess liquidity of banks, whose ratio to total dinar deposits amounted to a high 18.9 per cent in 2000 and 19.4 per cent in 2001, respectively.[106]

The *reserve requirements* of dinar and foreign currency deposits, which were the main monetary policy instrument during the 1990s, were also the primary monetary instrument used by the NBS throughout the stabilisation period. The mandatory reserve mechanism in the period pre-October 2000 to April 2002 required the daily maintenance of reserves, the amount of which was assessed every ten days – whereas the reserve base was comprised of dinar deposits only. As of 11 April 2002, the NBS transformed reserve requirements by widening the reserve base to include foreign currency deposits as well, and by extending the ten-day reserve maintenance period to a monthly level.

Throughout this period, the rate of reserve requirements ranged between 17 and 24.5 per cent for dinar and between 21 and 26 per cent for the hard currency deposits. We compare these rates with those suggested by Rostowski (1993) who proposes that in the

[106] According to the IMF (2002, p. 15), "structural conditions have encouraged liquid banks to hold excess liquidity, primarily due to the high costs of financial transactions (notably a 0.6 percent tax and fee on the value of all payment transactions), the scarcity of profitable lending opportunities, and institutional impediments to the banks' efforts to manage their liquidity. The latter include the absence of (a) an averaging provision for the reserve requirement, (b) adequate information to project daily liquidity needs because all payments are conducted by the payment bureau (ZOP), (c) deposit and reasonably priced lending facilities at the NBY, and (d) an operational interbank market".

countries in transition a rate of banks' reserve requirements be maintained above 25 per cent in order to ensure that money multiplier and money supply do not become extremely volatile.[107] The conclusion emerges that the experience of Serbia largely matches those recommendations, thereby confirming the universality of the authors' findings.

To supplement the reform of the banking sector and to encourage the development of an interbank market, the NBY also introduced new *deposit and lending facilities* during 2002. These facilities included the use of intraday credit, overnight credit, Lombard credit of varying duration, emergency credit and overnight deposits. On its deposit facilities the NBY had paid the related interest rates, whereas the credit facilities have been conditioned by the corresponding pledge of either foreign exchange deposits, foreign currency cash or NBY bills. For the purpose of maintaining the financial discipline of the banks, the NBY also introduced minimum credit rating requirements and based its deposit/credit facilities to banks upon their compliance with those requirements.

In its attempt to absorb the excess liquidity of banks and in order to switch from direct to indirect monetary policy instruments, the NBS (at the time the NBY) renewed the issuance of its short-term securities, that is, the NBY bills, in late 2000. According to the IMF's (2002, p. 18) assessment, "both the volume and the interest rates of the *NBY bills* have been relatively low". Up until 10 October 2003, the NBY's bills auctions were carried out *via* the Belgrade Stock Exchange and afterwards through the NBS's own electronic platform for auctions. The move towards open market operations was accompanied by the end of the issuance of the NBS's bills that took place on 31 January 2005. Simultaneously, however, the NBS organised its first *repurchase auction* of government securities on 31 January 2005. After the adoption of an adequate law[108], the Republic of Serbia issued long-term bonds that became both the property of the central bank and a suitable instrument for repo operations. During this first repo auction, the NBS temporarily sold government bonds worth a total of CSD 89.9 million, with an obligation to repurchase them in 14 days. The average repo rate stood at 17.6 per cent and their total repurchase price is CSD 90.5 million.

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[107] See page 32 of this thesis.
[108] Law on the Settlement of Obligations of the RS to the NBS (Official Gazette of the RS, No. 135/04).

After a somewhat more rapid reduction of the *NBS discount rate* from 26.34 per cent at the beginning of 2000 to 9.5 per cent at the mid-April 2002, the subsequent movements in the discount rate until April 2005 reflected only a moderately declining trend from 9.5 to 8.5 per cent. *Interest rates* exhibited downward trend throughout the period, but the cost of credit and the spread between lending and deposit rates remained high though negative in real terms. According to the IMF (2005, p. 67), the lending rates have been "primarily determined by the Euroibor, the country risk premium and changes in the dinar/euro exchange rate" due to a high level of euroisation (see Chapter IV).

- **Banking sector reform**

Banking sector reform started already in 2001 and has generally progressed quite fast. Up until mid-2003, the reform process was focused on transforming the commercial banking sector, leaving the institutional reform of the central bank to one side.[109] The reform of the banking sector aimed to consolidate the weakened banking sector in Serbia, a sector that suffered from bad loans, illiquidity, and a low level of financial intermediation. Moreover, two of the objectives was to introduce effective banking supervision, and to align the banking procedural operations with the standards of the Basel principles of prudential banking.[110]

The most demanding among the tasks relating to banking sector restructuring certainly was the closure of the four large state-owned banks (*Jugobanka*, *Beobanka*, *Beogradska banka* and *Investbanka*) accounting for two thirds of total assets at the beginning of 2002. The remaining insolvent banks were either liquidated or put under bankruptcy procedures in 2002. As a result, the number of banks in Serbia was reduced from more then 80 in 2000 to 43 as registered by end-2004. The fact that only the 6 largest banks have a cumulative share of about 53 per cent in the total balance sum (NBS, 2005a, p. 4) illustrates the need for further consolidation.

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[109] There was an attempt to adopt the new Law on the National Bank of Yugoslavia already in 2001, but it failed. Nevertheless, the administrative and organisational reforms of the National Bank of Yugoslavia (later the NBS) begun even before the institutional changes took place in mid-2003.

[110] Core Principles of Effective Banking Supervision of the Basle Committee on Banking Supervision. (so-called Basel I and Basel II principles).

The privatisation process in the banking sector in Serbia appears to be gradual, especially the privatisation of state-owned banks (see Table 3.8). Namely, in mid-2002, the Serbian government acquired stakes in 16 banks, accounting for around 50 per cent of assets of the solvent banks through debt-equity-swaps of Paris and London Club debt. The privatisation of those banks, however, only started in 2004.

Table 3.8. *The Republic of Serbia's share in the ownership of banks*

BANK	SEAT	REPUBLIC OF SERBIA'S SHARE
Vojvođanska banka	Novi Sad	98.65 %
Privredna banka	Pančevo	92.42 %
Continental banka	Novi Sad	94.64 %
Jubanka	Beograd	76.49 %
Panonska banka	Novi Sad	82.91 %
Credy banka	Kragujevac	60.58 %
Novosadska banka	Novi Sad	67.27 %
Niška banka	Niš	88.56 %
Srpska regionalna banka	Beograd	46.10 %
Čačanska banka	Čačak	33.06 %
Komercijalna banka	Beograd	29.08 %
Privredna banka	Beograd	16.36 %
Agrobanka	Beograd	14.90 %
Pirotska banka (under rehabilitation)	Pirot	97.27 %

Source: Official website of the Bank Rehabilitation Agency, www.bra.gov.yu [Accessed: 21.07.2005]

In the meantime, the privatisation of other non-state-owned banks continued through mergers and acquisitions carried out mainly by foreign banks. The start of operations by foreign banks or banks with predominantly foreign capital encouraged competition and increased the quality of services provided, but it also ensured a 37.7 per cent share of foreign ownership in the Serbian banking sector (see Table 3.9).

Table 3.9. *Ownership structure of the banking sector in Serbia on 31 December 2004*

In millions of dinars

	BALANCE SUM	SHARE (%)	CAPITAL	SHARE (%)
Domestic banks	318,041	62.3	79,845	80.3
- State banks	184,306	36.1	39,773	40.0
- Private banks	133,735	26.2	40,072	40.3
Foreign banks	192,051	37.7	19,605	19.7
Total	**510,092**	**100.0**	**99,450**	**100.0**

Source: National Bank of Serbia (2005b, p. 98).

Still, even after four years of transformation, the banking sector in Serbia remains underdeveloped, i.e. over-banked and under-serviced. This point is illustrated by the fact that, at the end of 2004, the sector's total assets amounted to a mere EUR 6.5 billion in absolute terms. Expressed in relative terms, the level of financial intermediation (measured by the banking sector's aggregate total assets as a percentage of GDP) stood at 38.8 per cent, comparing to a high EU-15 average of 200 per cent.

Nevertheless, the general assessment is rather positive. Banks in Serbia took responsibility over payment operations with the closure of national payment bureau on 1 January 2002. That confidence in the banking sector, which was completely lost during 1990s, was regained again is supported by the fact that total bank deposits have increased from 17.7 per cent of GDP in 2001 to 24.2 per cent of GDP in 2003. It is worrying, however, that the total lending of the banking sector in Serbia has dramatically declined from 38.1 per cent of GDP in 2001 to 18.0 per cent of GDP in 2003. On the one side, this occurrence came as a result of an increase in banks' credit and risk assessment skills. On the other hand, this points to the fact that banks still rarely meet the needs of enterprises in terms of maturities and price (interest rates), suggesting that further improvements are necessary.

3.5. Conclusion

This chapter aimed at revealing some specific features of Serbia's 15 year-long monetary and transitional experience (1989-2004), by presenting it in a clear chronological manner. Such an approach allows for the direct comparison of findings presented here with the theoretical literature and practical experience of other transitional countries discussed in the previous chapter. Also, this method enables the reached outcomes to be easily challenged by some proposed policy actions envisaged for future times, which will be presented in the following chapter. Moreover, the review offered here opens the door to deeper analysis of the underlining institutional structures of the Serbian monetary authority, that will be conducted in Chapter V.

Based on the first canvass, we conclude that the transition in Serbia differs from transition elsewhere for the following several reasons. Section 3.2 disclosed that the SFRY, which Serbia was a part of from 1945 until 1991, was the first to begin the transition process. However, the section also demonstrated that SFRY did not need to transition from a classical socialist economic set up, as it had developed its own specific type of market socialism: a kind of system which already resembled some of the features of a market economy, such as a two-tier banking system. The failure of Marković's programme, however, shows that even such an advanced initial position appears to be insufficient if there is no clear political will to support the economic programme or if the programme lacks the prompt application of stabilisation measures.

Additionally, Section 3.3 shows that Serbia paused its transition for a full decade (1991-2001), thereby applying a radical stop-and-go model of transition not implemented in other transitional countries. During those years, a very high inflation, combined with periods of hyperinflation, determined the negative tendency of (macro)economic performance in Serbia, further decomposing its previous economic achievements. This came as a result of both an isolationistic and ignorant attitude of the ruling political elite (see Palairet, 2001)[111] and the inconsistent sanctionist behaviour of the international community (see Pavlowitch, 2001, p. ix). The collapse of Avramović's programme of monetary reconstruction also confirms that no credibility of an economic programme can be secured if the programme lacks either adequate domestic political backing or necessary international recognition.

Section 3.4, which describes the period between 2001 and 2004 when transition in Serbia was re-commenced, demonstrates the suitability of conventional propositions established back in the late 1980s and early 1990s in the form of the Washington consensus. On top of this, the Serbian experience demonstrates that the time is needed for an economy in transition to restructure, resume growth, and gain on its external competitiveness, implying that a somewhat gradual approach to trade liberalisation and disinflation should be taken.

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[111] The economic consequences of the regime of Slobodan Milošević are most clearly and comprehensively presented by Palairet (2001) who underlines that the erosion of human capital, corruption, and regime's ignorance towards the other economic trends represent its most unforgivable legacy.

More specifically, it shows that by disinflating very quickly, the central bank imposes on itself an additional constraint; that is, an obligation to keep the inflation at a 'historically' low level in the post-stabilisation years. It cannot, according to Bofinger (1990, p. 5), be excluded that a central bank has to produce some periods of surprise deflation in order to convince private agents of its anti-inflationary stance. But, as the Serbian case shows, this exercise must be counterbalanced with the costs of disinflation and exchange rate rigidity, which come in the form of widening external imbalances. The lesson emerges that rapid disinflation combined with the real appreciation of domestic currency appears to be unsustainable in the long run, as central bank cannot successfully target both inflation and exchange rate. The conclusion also seems to be in line with the results obtained by Šević and Šević (1998) and Hilbers (1993).[112]

Nevertheless, it is clear from our analysis that the period from October 2000 thereafter represents the longest period of continuous efforts to stabilise the economy contemporary Serbian economic history.[113] The lessons drawn are that (i) real instead of nominal democracy is needed for substantial reforms to be implemented, (ii) a complicated constitutional structure does not represent an impediment to reforms if there exists a genuine domestic political and international support to reforms, (iii) international support represents a necessary but insufficient condition for reforms to succeed, and (iv) a time of extraordinary politics, outside the scope of collapse of communism, may serve as catalyst for difficult reform tasks, but these periods remain relatively short.

Based on those findings, we raise the question of whether this relatively stabilised economic position will be maintained until the end of transition and beyond. The answer appears to depend largely on future policy decisions in both spheres, political and economic. In this work, however, we chose to explore the potential for further developments of monetary and exchange rate regimes (Chapter IV) and the central bank's institutional framework (Chapter V). It is our aim to contribute to the overall understanding of the need for an increase in institutional credibility and democratic accountability that has been lacking in Serbia for decades.

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[112] See the analysis in Chapter II of this thesis.

[113] In contrast, Arsić *et al.* (2005, p. 127) argue that period from October 2000 thereafter represents "the longest period of economic stability in the newest economic history of Serbia".

Chapter IV Serbia's New Monetary Policy Strategy

4.1. Introduction

This chapter analyses the monetary policy issues during the transition. The theory of economic transition has offered a view by which the countries longing for EU membership should transit toward a particular – European model – of market economy (see Kornai, 1990). In approaching the EU, several options are available and it is the task of this chapter to disclose them. Thus, our main question in this part of the thesis revolves around the issue of monetary and exchange rate policy options for Serbia in approaching the EU. A complementary question is that of timing in the design of an adequate strategy and means for its implementation. As a result, we shall also analyse the conceptual issues surrounding the monetary policy strategy and its composite parts: monetary policy objectives, targets and instruments.

The process, however, is not free from the outside influences, as it depends on the transmission mechanism and prevailing economic conditions. This is so because the monetary policy itself does not represent an isolated case, but it forms part of a much broader macroeconomic milieu, as recognised by the monetarists[1] in the late 1960s. Additionally, as explained previously, the macroeconomic variables of transition economies exhibit certain specific features; the output, inflation, internal and external imbalances and other variables seem to deviate from its usual levels so much that Blanchard (2000) even classifies them under the 'pathologies' (e.g. hyperinflation). Moreover, the central banks in transition generally lack the expertise in monetary policymaking within the layout of emerging market economy and are devoid of knowledge about how this rising economic setting operates.

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[1] Term 'monetarists' stands for the followers of the so-called 'Monetary Theory', which was developed by Milton Friedman during the 1960s. The theory opposed the then prevailing belief, set up by John Maynard Keynes in the 1930s, that fiscal policy is the key to fight against recessions and that changes in the interest rate have little effect on demand and output, leading to the conclusion that monetary policy is not working well. Quite opposite to the Keynesian view, the monetarists argue that movements in money can indeed explain fluctuations in output (see Blanchard, 2000).

In face of uncertainty about the true structure of an economy and the shocks to which the economy is exposed, policymakers and economic agents may disagree about the macroeconomic effects of monetary policy and thus about the appropriate policy actions ('what monetary policy can and cannot do'). Similarly, they may have diverging views about the adequate monetary policy targets and different understanding about the monetary transmission mechanism, that is, the channels through which the monetary policy decisions are passed on into the real activity (see Lewis and Mizen, 2000). The debate is abundant. Thus, the last part of the chapter provides the overview of Serbia's monetary characteristics and experience with monetary and exchange rate regimes.

4.2. Monetary Policy Strategy: What Monetary Policy Can and Cannot Do?

Serbia's monetary history of the last 15 years, as described in the previous chapter, is pivotal to the comprehension and assessment of the country's future monetary policy actions. One viewpoint is that, throughout the period, the position and role of the Serbian central monetary institution have been challenged by a distorted public perception of what monetary policy *should* had done for the Serbian society. The causality, however, may have worked in a reverse direction and so another premise is that the actual position and the functions performed by the central bank in Serbia over the years have lead the public to believe that the National Bank of Serbia *could* had done more (or less, ironically) then suggested by the monetary economics theory.

During the 1990s, misconceptions came about as a result of an abusive behaviour of elected politicians in terms of central bank and monetary management, as meticulously explained by Dinkić (2000). Since 2000 thereafter, the politicians have become more disciplined despite the fact that the legislative frame was not immediately altered (see Chapter V). But, some residuals of public misconceptions remained till today. We argue that, at least partially, they are rooted in basic misunderstandings about the monetary policy limitations. Therefore, we chose to go back to explaining the *theoretical fundamentals* underlining the playing field within which the central bank of Serbia must operate in future in order to regain its dwindled credibility.

In order to define the borders of a mentioned central bank playing field, one must answer the question of what monetary policy carried out by a central bank, including the National Bank of Serbia, *can* and *cannot* do (see Mishkin, 1996). The issue is, thus, a general one. In other words, to maximise the utility function of a central bank one must look at the ultimate economic welfare a central bank can bring to a society. An extended deliberation in the case of Serbia requires that a question of what the National Bank of Serbia *should* do, is also posed.

In institutional terms, the lawmakers draw the boundaries of what monetary policy can and cannot do *via* inclusion of monetary policy objectives – price *and* financial stability – into the central banks' institutional frameworks (i.e. central bank laws). In practical terms, those boundaries are defined by some generally accepted findings of economic theory and track record of monetary policy conduct of various countries over the years. The theories that predominantly shaped the economists' considerations over the monetary policy during the 1960s had two main strands.

The first relied on the assumption that the macroeconomic models, which existed at the time, are sufficiently advanced and that they could be employed to accurately predict the effects of changes in monetary and fiscal policy on the aggregate economy. The second assumption was that there exists a long-run trade off between unemployment and inflation that could be exploited, as advanced by Samuelson and Solow (1960)[2]. Both components sponsored the so-called *monetary policy activism* requiring an expansionary monetary policy approach to be used whenever unemployment increases above its 'natural rate'[3].

In the late 1960s and during the 1970s, the *case against monetary activism* strengthened due to advancement of monetarists' theories. The first set of arguments was based on a couple of presumptions. Firstly, according to Mishkin (1996, p. 15), "Milton Friedman staked out his famous position that activist policy would be counterproductive because policy, and particularly monetary policy, affects the economy only with *'long and variable lags'* ", undermining the results of then prevailing macroeconomic models.

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[2] See Mishkin (1996).

[3] According to Lewis and Mizen (2000, p. 216), the natural rate of unemployment "represents the long-run level of unemployment consistent with any level of nominal wage inflation, given that there is no money illusion and that price expectations correct for nominal changes in wages".

Moreover, the 'Lucas critique' came into play in the mid-1970s based on the rational expectations theory. The critique emphasised the misleading nature of existing macroeconomic models' results on the grounds that they had treated expectations as structural parameters (that is, unchanged), whereas the *expectations change* in line with variations in policy preferences.

The second collection of arguments against monetary policy activism came from the understanding that there is no trade off between inflation and unemployment in the medium- or long-run, i.e. that the *Phillips's curve is vertical* (see Chapter II). In relation to that, Lewis and Mizen (2000, p. 216) assess the following:

> "Friedman (1968*a*) and Phelps (1970) put forward the hypothesis that this was because the process by which wages were negotiated, which determined the rate of inflation, involved expectations of future conditions. Their contention was that the Phillips curve was failing to account for the impact of expectations on the wage inflation process and as a result of the misspecification was failing to explain the true nature of the relationship between inflation and unemployment".

The third pool of opinions against monetary policy activism gathered around the *time-inconsistency theory*. The first paper to bring the issue of inconsistency of optimal pubic policy, as explained in Chapter II of this thesis, is the paper by Kydland and Prescott (1997). The work of Barro and Gordon (1983) followed. The authors build the theory around the notion that a government's optimal policy option at a given time may not be optimal in the subsequent period. In other words, they found inconsistency in selection of government policy between one period and another due to a simple fact that the public may, by trusting the government, act upon its initial policy announcements and thus induce the government to re-optimise its policy in face of altered circumstances.

In terms of monetary policy, all these theories worked in a way that they formed the precincts to what monetary policy can and cannot do in achieving a desirable economic output for society, which was our starting question. Namely, the fact that there are long *and* variable lags in the conduct of monetary policy limits the central bank in subordinating its expansionary policy to short-run decrease in unemployment or increased output, as usually instructed by politicians concerned with the re-election of their mandates.

Equally, the theory of time inconsistency points to a need to reduce the temptation of monetary authorities to create surprise inflation – motivated by reduction of unemployment, increase of fiscal revenues, smoothing of interest rates, or lessening of excessive balance of payments deficits (see Cukierman, 1992) – above private's agents inflation expectations.

In practice, the applicability of those theories is evident in lawmakers' attempts to institutionally constrain the central banks' behaviour and to utilise its public function by coercing it to concentrate on *socially optimal* policy outcomes. The Serbian monetary history of 1990s, however, confirms the political economy's argument that what is considered to be the best policy option in terms of country's welfare does not necessarily coincide with what is considered to be the best policy option by the mischievous politicians (see Chapter III).

Then again, in normal circumstances, these two should coincide. In such case, the structural characteristics of an economy and the nature of shocks to which a country is exposed as well as the authorities' prioritisation over economic objectives determine the choice of monetary policy strategy that is to introduce stability and predictability into the system. Besides, considerations over the monetary policy objectives, targets, instruments, and operational procedures also play a role.

4.2.1. Elements of a monetary policy strategy

Nothing in life, and thus neither a monetary approach to a given problem at a given time, is constant. However, although the content and expressions may change, the notions in principle remain the same such as, for example, *stability* (political stability, economic stability, financial stability, monetary stability, price stability, etc.). For decades now the monetary economists have been occupied with the *objectives* of securing the price and financial stability. The duality derives from the evidence pointing to the benefits that accompany both, price and financial stability.

The gains for a society associated with the *price stability* stem from the fact that price stability promotes an economic system to function more efficiently (Mishkin, 1996, p. 19). On the other hand, it was found that the economic costs increase in line with the raise in inflation due to several occurrences.[4]

The benefits associated with *financial stability* derive from the reduction (elimination) of fluctuations in price level, which otherwise produce disruptions in financial markets due to existence of debts denominated in foreign currencies. This, in turn, may trigger financial crises and further destabilise the economy. Consequently, a prudential central bank approach to banking supervision and regulation as well as its ability to act as a lender-of-last-resort make crucial elements of financial stability. Although strongly backed by numerous arguments, the considerations about the monetary policy objectives put a constraint on central bank independence. This is because nowadays in most countries the central banks do not have the liberty to select their ultimate policy goals independently.

Namely, we have seen in Chapter II that the central banks only have 'instrument independence' and that the objective of securing the long-term price stability is assign to them by politicians (by enforcing a central bank law). Goodhart (1993) argues that this is not negative in itself as it indirectly pushes the central bank into the political arena, where it can learn how to practice the accountability and gain credibility *vis-à-vis* politicians and general public. On the other hand, Cukierman (1993, p. 5) asserts that "some ambiguity about the emphasis it [central bank, auth. remark] puts on alternative objectives" is desirable, as it allows the monetary authority to produce surprises, therefore actively reacting to changes in real economy in the short- and medium-term.

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[4] Firstly, the so-called 'shoe leather' effect brings about the costs of economising on the use of non-interest-bearing money, estimated to account to more then 1 per cent of GDP for economies where inflation raises above 100 per cent (see Bailey, 1956). Secondly, higher inflation induces more financial transactions as speculators find it more profitable to act as mediators then to invest in production, which may cost the economy up to several percentage points of GDP (see English, 1996). Thirdly, high inflation affects decisions about future expenditures by creating shifts in investment decision patterns from long- to short-term, and by generating alterations in investors' preferences from nominal to real assets. Fourthly, high inflation produces distortions in the tax system with resulting misallocations of capital. Fifthly, due to the fact that inflation erodes the level of productivity and the base from which the economy grows, it was calculated that, on average, 1 per cent rise in inflation could cost an economy from 0.1 to 0.5 per cent of its rate of growth (see Fischer, 1993). Finally, the process of disinflation itself registers loss in terms of widened external accounts and possibly output (see Cottarelli and Doyle, 1999, in Chapter II).

We find it important to investigate in what way has Serbia approached all these considerations in practice and how has the thinking of politicians changed over the last 15 years with respect to the tasks they have been assigning to the Serbian central bank. Serbia of today, like many other modern countries in the world, has ensured that its central bank has price stability as its ultimate monetary policy objective. However, it took 15 years until the time has come for some new and progressive generations to get into position to enforce this institutionally (see Chapter V).

In operational terms, however, the objective of price stability appears to be imprecisely defined. Literally speaking, price stability would mean that no changes in aggregate prices in an economy take place. This, however, does not make much sense in the present ever-changing global economic environment. Therefore, the economically meaningful definition of price stability should include the stability of prices of goods that are produced or consumed in an economy *on average*. Furthermore, if a weighted average of the prices of goods is taken to denote the price level in that economy, then the price stability should also mean the stability of the price *level*. In this, it is important to know that "the price level and the value of money always move in precisely opposite directions" (Bofinger, 2001, p. 153), thus strengthening the rationale for the price stability objective.

Having cleared the meaning of the price stability[5], one should move to a more practical question of means for achieving it. For this to be possible, however, it is essential that a measure, i.e. an indicator, of changes in price level is known. For this purpose, the economists have constructed a *price index*, which rate of increase is recognised as the *inflation rate*.[6] It is interesting that the EU has constructed a unique *harmonised index of consumer prices (HICP)*, which measures inflation in all EU Member States in the same way. There is also the concept of *core inflation*, which derives from the cost-of-living indices, but excludes certain parameters.[7]

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[5] There exists a difference between quantitative determination and conceptual meaning of price stability.

[6] Bofinger (200, pp. 154-157) sketches the main issues (e.g. selection of products in index and attached weights) surrounding the selection of an adequate price index and explains some main prices indices concepts, such as the 'basket of goods' (Laspeyres index) or the cost-of-living index.

[7] "For the communication with the public, core inflation rates have the disadvantage that they are not necessarily regarded as a relevant information, since they are not always related to changes in the cost of living. Thus, for the HICP the ECB has decided not to adopt the concept of a core inflation rate" (Bofinger, 2001, p. 157).

Aforementioned indices provide useful information to central banks and to general public about movements in the inflation rate. But, in order to be in a position to influence changes in inflation rate, the central banks must develop some operating tools, that is, *rules and targets*. The case for rules strengthened during the 1970s after recognition that in the long-run there is no trade off between inflation and unemployment and that discretion of monetary authorities may just add to uncertainty already inherited into the economic systems.

The targets appeared to be results of monetary policy makers' search for 'simple rules' to which they can adhere in pursuing its more general objective of price stability. Thus, an explicit monetary policy target should guide inflation expectations and reduce uncertainty by setting a pre-announced monetary policy path. Targeting, however, does not imply that judgemental decisions of policymakers are disregarded or that exclusively a strict rule-based approach must be applied. Rather, a monetary policy targeting should mean that the two approaches are combined so as to co-enforce the overall process of monetary policy making *via* introduction of increased consistency and forward-looking into a stipulated monetary policy programme, and by making space for imperfect mathematical computations of targeted aggregates.

The selection of monetary policy targets depends upon the structural characteristics of an economy as well as on the characteristics of the targets themselves. In relation to this, Houben (2000, p. 74) sketches the necessary/minimal attributes a variable should have in order to qualify for a monetary policy target: "[T]he monetary policy target should be: (i) sufficiently controllable; (ii) predictably related to outcomes under the end objectives of monetary policy; (iii) a leading indicator of developments in these end objectives; (iv) readily communicable to the public at large; and (v) monitorable on a timely, frequent and reliable basis".

Herein, the difference may be made between the explicit (i.e. ultimate, operating) and intermediate targets. The concept of intermediate targets was introduced once it was recognised that the monetary policy, because of time lags that exist between the changes in operational targets and effects on the ultimate goal, can react only after disturbances occur. Following a seminal article by Poole (1970), the choice among intermediate targets scaled down to a price (interest or exchange rate) versus quantity (money).

Ultimately, however, the selection depends on the transmission mechanism and links, which exist between monetary policy objectives, targets and instruments. An intermediate target is set to perform two very important functions. The first is to serve as a transparent communication device between the economic agents and central banks. The second is to establish a tangible benchmark against which the central bank accountability can be measured. Indirectly, thus, the targeting is meant to increase the discipline and credibility of monetary policymakers. Unfortunately, none of this is achieved in Serbia, yet.

The operational and intermediate targets are impacted by adjustments in the monetary policy *instruments*, which can be either direct (direct credit, credit ceilings, interest rates controls) or indirect (reserve requirements, refinance/discount facilities such as rediscount and Lombard facilities, government and central bank papers).[8] The choice of monetary policy instruments depends on the actual characteristics of an economy, its underlying transmission mechanism, and financial system development (see Hilbers, 1993). The example of industrialised countries, which underwent a dynamic liberalisation and deregulation of its financial markets during 1970s and 1980s, illustrates this point. In this, the scholars[9] argue, a widespread use of indirect monetary instruments both, aimed at, and was, an unavoidable result of financial innovations, which occurred at the time.

De Melo and Denizer (1997) examine monetary policy in 26 transition countries of Europe and Central Asia in the period 1989-1995 and conclude that the use of credit ceilings is particularly helpful in stabilisation years, although the effective stabilisation (and financial depth) is accompanied by elimination of credit controls. The authors also find that financial depth benefits from evolution of markets for government paper and that inflation in transition appears to be associated with the abolition of direct credit and introduction of a market-oriented refinancing window. Alexander, Baliño and Enoch (1995) argue that introduction of indirect instruments goes in hand with increased effectiveness of monetary control and amplified efficiency of financial intermediation (*via* market based allocation of financial resources).

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[8] "In general, direct instruments take the form of regulations while indirect instruments work through markets" (De Melo and Denizer, 1997, p. 7).

[9] See Hilbers (1993, p. 1) and Alexander *et al.* (1995, p. 27) for additional references; both papers point to Kneeshaw and Van den Bergh (1989) and Kasman (1992).

Monetary authorities wishing to introduce indirect instruments are, nevertheless, susceptible to certain costs. These costs are bigger the less progress is made in concomitant reforms, which require following actions to be taken: (i) insulation of monetary policy from deficit financing, (ii) strengthening and integration of money markets, (iii) restructuring of banking system and competition fostering, (iv) adaptation of supervisory and regulatory framework to market conditions, and (v) bolstering of the technical capacity of the central bank. To this, Alexander *et al.* (1995. p. 27) add the stable (macro)economic conditions, which although auspicious to adoption of indirect monetary instruments, are "neither necessary nor sufficient" for successful transition to indirect monetary policy instruments.

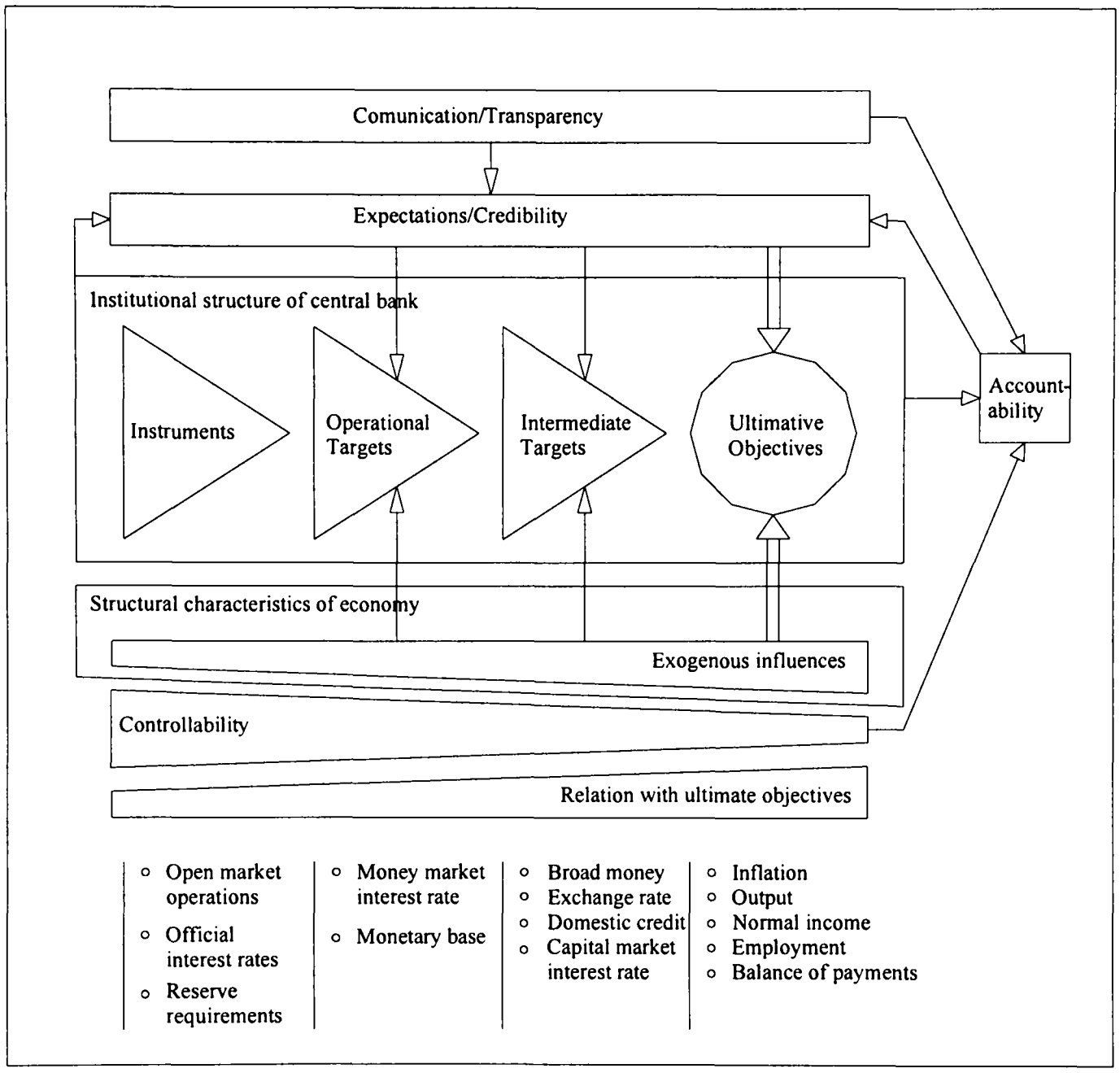
All these factors are likely to affect the pace of transition from direct to indirect instruments, which happens to last 3.7 years on average (Alexander *et al.*, 1995, p. 31). Transition to indirect monetary instruments clearly does not happen over night; it requires sequencing. The sequencing path, however, can only be tentative as transition itself depends on a mix of many factors and is, thus, country specific. Accumulated evidence from a number of countries (industrialised and non-industrialised) suggests that one can distinguish among three transitional stages. *Initial stage* assumes that: (i) liquidity overhang or liquidity is absorbed, which is best done by reserve requirements, (ii) temporary accommodation mechanism (lender-of-last-resort) is established, usually *via* overdraft or Lombard facilities, (iii) funds are provided to the market through a credit facility (credit auctions), and (iv) elimination of interest rates controls are initiated in line with legal and technical preparations for development of money and government securities markets. *Second stage* corresponds to issuance of government or central bank securities, which should foster developments of secondary markets and introduction of repurchase operations (repos). Such open market operations should be accompanied by reduction in reserve requirements and short-term credit auctions, Lombard window or bill rediscounting (Alexander *et al.*, 1995). *Third stage* involves accelerated development of money and secondary market for securities that necessitates further refinements in the design of monetary instruments. Comparing this with the findings of Chapter III, we may conclude that Serbia is currently in the second stage of transition and that a vigorous reform potential will have to be applied if this process is to be acomplished.

Monetary policy instruments together with the central bank operational procedures make the so-called monetary policy *operational framework*. Operational framework can be more or less complex and may include a range of economic and (macro)econometric analyses. For example, the monetary policy strategy of the European Central Bank is based on two pillars, which represent a tool for analytical evaluation and cross-checking of all information relevant for assessing the risks to price stability (see ECB, 2004). The two-pillar analytical framework encompasses the conduct of separate economic analysis and monetary analysis, the results of which are then compared and cross-checked.

According to the ECB (2004, p. 55), the *economic analysis* focuses on the developments in economic and financial variables (developments in overall output, aggregate demand and its components, fiscal policy, capital and labour market conditions, a broad range of price and cost indicators, developments in the exchange rate, the global economy and the balance of payments, financial markets, and the balance sheet positions of euro area sectors) and the short- and medium-term risks they pose to price stability. Due attention is also paid to the nature of shocks to which the economy is exposed. A complementary *monetary analysis* relates to a comprehensive assessment of liquidity and credit conditions based on the counterparts (in particular, loans to the private sector) and the structure (in particular, M1) of a broad monetary aggregate M3, for which the ECB announces a reference value, upholding the M3 growth compatible with its primary goal of price stability over the medium term. Based on our interviews with the NBS Vice Governors, we conclude that the NBS's research capacity is still further away from the best practices and that it will need to be substantially strengthened.

While the main function of monetary policy objectives and targets is to set *what* is to be achieved ('doing the right thing'), the monetary policy operational framework provides answer to the question of *how* that is to be achieved ('doing the thing right'). In combination, all these elements (objectives, rules and targets, instruments, operational procedures) make the *monetary policy strategy*. In Houben's words (2000, p. 2), "monetary policy strategy is considered to consist of the specification of the intended monetary reaction function to economic developments as well as the communication of this reaction function and of actual policy decisions to the outside earth".

Chart 4.1. *Elements of monetary policy strategy and transmission mechanism*



Source: Houben (2000, p. 3).

The above definition and its graphical presentation attest that the elements of the monetary policy strategy are inseparable from the structural characteristics of an economy and nature of shocks to which the economy is exposed. This is so because the controllability over monetary variables induced by shocks (see Buch, 1995) and the stability of the relation between the monetary and real parameters depend on the underlining transmission mechanism, a comprehensive assessment of which ensures that monetary authorities' decisions are made in a forward-looking manner, and that they are transparent and credible.

4.2.2. Factors influencing the choice of a monetary policy strategy

Each and every economy in the world is constantly exposed to certain types of economic shocks. Frequently, these shocks occur simultaneously and are thus more difficult to trace and to react to. Also, quite often, they are only evident *ex post*, i.e. once they happen. Leaving an economy everywhere and at all times exposed to the shocks is not the best policy option and is potentially very costly. Therefore, the governments and central banks are in most cases called upon to react. However, in order to assign to the monetary policy a realistic task of responding only to those shocks and to the extent to which the central bank policy actions may suppress the negative effects of shocks without introducing additional instability into the system, one must first assess the nature of shocks to which the economy is exposed.

The shocks may stem from the monetary (e.g. disturbances to money demand) or real (e.g. changes in demand (expenditure), or supply side of the economy such as abrupt productivity changes or changes in energy prices) disturbances. They may be of domestic (endogenous) or foreign (exogenous) origin, temporary (i.e. self-reversing) or permanent, and symmetric (i.e. not country specific) or asymmetric. Extracting information about the shocks hitting the economy is, clearly, not an easy task. Depending on the type of shocks, the monetary policy will more or less successfully respond to the price and output growth fluctuations resulting from those shocks. In this, the selection of monetary policy targets appears crucial, but it is additionally burdened by the fact that only the knowledge about the nature of *past* shocks exists, whereas what matters is the character of possible *future* disturbances. Some tentative guidelines are, nevertheless, given in Table 4.1.

At a high level of generalisation, the following relationships between the optimal policy targets and different types of shocks can be drawn. If shocks are primarily of monetary nature, then an interest or exchange rate target will shelter the economy better. To the extent that the economy is exposed to real disturbances, a money target will insulate price and output fluctuations more effectively. In cases when shocks come from the supply side, the preferred monetary rule is more ambiguous. Similarly, according to Houben (2000, p. 14) "nothing conclusive can be said about the superior regime under foreign shocks". One recommendation, although constrained by specific circumstances,

for monetary authorities is to accommodate the shock if it is temporary and to adjust interest/exchange rates if the shock is permanent.

Table 4.1. *Optimal monetary policy target under different types of shocks*

Type of chock	**Monetary policy target and objective**			
	Price target (Interest rate or Exchange rate)		**Quantity target** (Money supply)	
	Stability of output	Stability of prices	Stability of output	Stability of prices
Domestic monetary shock	+	+	-	-
Domestic real demand shock	-	-	+	+
Domestic real supply shock	? + / –	? + / –	? + / –	? + / –
External nominal shock	-	-	+	+
External symmetric shock	(outcome according to same domestic shock type, but with stable exchange rate)			
Other external shock	?	?	?	?
Temporary shock	+	+	-	-

Notes: With given type of shock, pursuing stated monetary policy target enhances (+) respectively undermines (-) fulfilment of stated policy objective; a question mark (?) indicates that the superior monetary policy target is unclear.

Source: Houben (2000, p. 16)

Due to the complexity and uncertainty about the stated disturbances, it is important that central banks regard the choice of monetary strategy as an *ongoing process*. Such approach will equip them with the greater flexibility in situations when some unanticipated disturbances occur requiring a swift monetary strategy switch. The choice of monetary policy strategy, however, depends not only on the nature of shocks but also on the structural characteristics of an economy as these determine the ability of that economy to absorb the disturbances. In this, the following structural aspects play a role: (1) wage flexibility, (2) labour mobility, (3) prevalence of budgetary stabilisers, (4) openness, (5) capital mobility, (6) diversity of the production base, (7) financial structure, and (8) endogeneity in the monetary strategy choice (see Houben, 2000).

The level of *wage flexibility* considerably influences the choice of monetary strategy, especially *vis-à-vis* the exchange rate regime. If wages are highly or fully indexed, then any attempt to nominally adjust exchange rate would be offset by the nominal adjustment in wages, leaving real wages unchanged. On the other hand, if real wages are fully flexible, both flexible and fixed exchange rate regimes work in terms of stabilising output in case of disturbances. However, if wage flexibility is constrained by (downward) nominal wage rigidity, the flexible exchange rate better responds to shocks; the relationship vanishes with the increased level of nominal wages indexation. In this, as argued by Houben (2000, p. 17), the degree of nominal wage rigidity *per se* does not represent the main problem, but rather the institutional characteristics of labour markets and especially intermediate systems of wage barging, as an option in between the centralised and decentralised systems of wage barging.

Regarding *labour mobility*, two views are considered relevant. The first opinion derives from Mundell's (1961) argument that a low labour mobility requires greater exchange rate flexibility and that the fixed exchange rate regime appears impotent in the face of respective economic disturbances. Herein, the higher the asserted uncertainty about the prospective employment and income opportunities elsewhere, the lower is the labour mobility[10]. Therefore, the relative stability of prospective income and exchange rate itself are factors, which influence the choice of monetary strategy (exchange rate *versus* monetary target) more than the level of labour mobility (Houben, 2000, p. 19). On the other hand, as viewed from a single country perspective, if other mechanisms (e.g. budgetary policy) – apart from mobility of labour – are engaged in accommodating shocks, the fixed exchange rate regime may be compatible with labour immobility.

Theoretically, due to the prevalence of *budgetary stabilisers* (e.g. wage freeze), even under the fixed exchange rate regimes, the negative effects of asymmetric shocks can be offset. In practice, however, because of a strong pro-cyclical tendency and sharp increases in government debt, the exchange/interest rates remain the preferred solution. Besides, the effectiveness of fiscal measures is directly correlated with the size and mobility of the tax base and limits it poses on increase in taxes, as it is the case in Serbia.

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[10] For Houben (2000, p. 19), "labour mobility is a function of the degree of economic uncertainty facing an individual".

There are a few arguments in relation to the influence of a country's *openness* to the selection of a monetary policy strategy. The first is the efficiency argument implying that a more stable exchange rate better insulates the economic disturbances the greater the degree of openness (i.e. the larger the share of tradables sector in the economy). Namely, the more open the economy, the greater role of exchange rate in determining relative prices; thus, the exchange rate stability makes a prerequisite for domestic price stability. Besides, in such circumstances, the accommodation of monetary shocks happens *via* balance of payments. An opposing argument states that greater openness increases vulnerability to external disturbances, thereby entailing larger exchange rate flexibility. Additionally, in cases where wages and prices are *not* closely linked to exchange rate movements, unlike in Serbia, a more flexible exchange rate effectively stabilises output in face of disturbances in domestic demand or external shocks. Altogether, more openness seems to favour exchange rate stability, but the ultimate choice of monetary strategy remains somewhat ambiguous.

The openness of an economy in terms of the financial sector, i.e. the extent of its capital liberalisation and financial integration, considerably influences the choice of monetary strategy. In this, according to Houben (2000, p. 24) there exist the 'incompatible triangle' among unrestricted *capital mobility*, monetary policy autonomy and exchange rate stability as, at any point in time, out of these three objectives, only two can be fully met. The causality works in the following way; the larger is the capital mobility, the greater is the country's exposure to foreign shocks, especially to changes in international interest rates, and, thus, less effective is the exchange rate targeting in achieving domestic monetary policy objectives. Notwithstanding the above relationship, it should also be noted that the greater capital mobility facilitates the conveying of monetary shocks abroad. Highly relevant for transitional countries wishing to join the EU and thus aiming at eliminating the prevailing capital controls such still exist in Serbia (see Chapter III) is the effects of capital liberalisation to monetary policy instruments as some of them tend to lose its strength in view of increased capital mobility. Taken together, all those considerations suggest that removal of capital controls should be accompanied by direct inflation or nominal income targeting, and not by intermediate solutions such as money or exchange rate targeting (see Houben, 2000).

The experience of Western European countries forming the EU, illustrates the point that greater *diversification of production base* reduces the reliance of monetary policy on fixed exchange rate as more diversification by itself reduces the likelihood for adverse shocks (see Houben, 2000). Also, in the case of a higher degree of diversification, the shocks that occur appear to be more symmetric. The argument, however, diminishes in case of transitional economies that exhibit different production and trade patterns.[11] Implication for monetary policy is that in those economies greater exchange rate flexibility may be required, which is a point of special interest for Serbia.

Limited knowledge about the monetary policy transmission channels precludes any conclusive policy recommendation to be made in terms of optimal degree of monetary activism under the given country-specific characteristics of its *financial structure*. The differences among countries in financial structures derive from dissimilar private sector financial arrangements reflected in various degrees of indebtedness and debt maturities, interest rates variability preferences, and preferences towards alternative forms of financing (banking or other). Additionally, within each category, the different institutional implications appear to be an important factor for monetary considerations. Generally speaking, though, the more those factors determine the structure of balance sheets towards a greater sensitivity to changes in short-term interest rates, the weaker is the argument for application of exchange rate oriented monetary policy strategy.

Finally, it is important to look at the *endogeneity* of adopted (or intended) monetary policy strategy, i.e. its effects on the structural characteristics of economy and behaviour of economic agents ('Lucas critique'). In the case of monetary targeting, this implies analysis of changes in statistical relationship between a monetary aggregate and nominal income induced by strategy implementation, as suggested by 'Goodhart's Law' (see Houben, 2000). In the case of exchange rate targeting, this requires careful considerations about the effects the exchange rate fixity has on the structural characteristics of an economy (e.g. labour market reforms aimed at reducing rigidities), which initially may work against the option of exchange rate targeting.

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[11] As explained in Chapters II and III of this thesis, the share of production of primary commodities (agriculture, energy and mining) in transition economies is much larger then in industrialised economies, whereas the share of manufactures and services is considerably smaller. Moreover, the composition of exports and imports is largely unfavourable and thus prone to terms-of-trade shocks.

4.2.3. Money, exchange rate and inflation targeting

As explained earlier, monetary policy targeting tends to increase the central bank transparency, accountability and credibility. As a result, targeting appears to be beneficial especially to those central banks lacking the above-mentioned attributes. We argue that the National Bank of Serbia is among the central banks which are in deficit of democratic accountability, comprehensible communication strategy and genuine credibility. Apart from the implementation of institutional mechanisms for achieving those qualities, which will be elaborated in the subsequent chapter, the operational framework of a central bank with the monetary target at its centre, may serve the purpose. In this, a whole set of practical single monetary targets is available to central banks (money, domestic credit, interest rate, exchange rate, nominal income, direct inflation) alongside with the implementation of a combined targeting approach. A synthetic overview of main advantages and disadvantages of respective targets is given in the following Table 4.2.

Table 4.2. *Strengths and weaknesses of monetary policy targeting options*

Monetary policy target	Relation to end objective	Control-lability	Leading indicator properties	Communi-cability	Statistics	Main concerns
Money	0	0	+	+	0	Stability/controllability of money demand
Domestic credit	0	0	0	–	0	Absence of nominal anchor
Interest rate[1]	–	+	0	–	+	Absence of nominal anchor
Exchange rate[2]	0	0	+	+	+	Optimal currency area considerations
Nominal income	+	–	–	–	–	Reliability of (forecast) data
Inflation[3]	+	0	+	+	–	Supply shocks
Combined targets[4]	+	–	+	–	0	Consistency of targets

Legend: Neutral (0), positively correlated (+), negatively correlated (–).

Notes: [1] Short-term nominal interest rate.

[2] Assumes broadly similar economic structures, shocks and preferences, as well as stability oriented policies in the anchor country.

[3] Assumes that forecast inflation, rather then actual inflation, is the policy target; this enhances the leading indicator properties of the target, but complicates its statistical measurability.

[4] Outcome depends on target combination. Here, a dual strategy with money and inflation target is assumed, as well as pragmatic monetary implementation.

Source: Houben (2000, p. 120)

It has been confirmed empirically that the choice of a superior monetary policy target is a country-specific process that evolves over time, but that nonetheless some normative recommendations do apply, regardless of specificities of any particular economy. These mainly point to the fact that interest rates and domestic credit are loose targeting options because they do not provide a monetary authority with a nominal anchor.[12] Similarly, nominal income target is difficult to forecast and is, thus, not very reliable or transparent, while a mixed approach carries the risk of inconsistency of multiple targets, which decreases communicability and raises discretion. Consequently, the selection narrows down to the following three targeting options: money, exchange rate and inflation.

The selection of intermediate target leans essentially on the transmission process through which the central bank spreads monetary impulses. There, however, is no one single transmission channel. Bofinger (2001, p. 72) provides a summary of key theories that explain the channels for transmission:

1. "the channel of the *quantitative theory*, which relies on a direct impact of the money supply on macroeconomic demand;

2. the *interest rate channel* (or aggregate demand channel), which relies on changes in the structure of interest rates and their impact on investment and other components of aggregate demand (the IS/LM model, Tobin's *q*, yield structure);

3. the *expectations channel*, which relies above all on the impact of inflation expectations in wage negotiations; this mechanism is usually presented in the form of a Philips curve, which operates via the supply side of the economy [...]

4. For smaller open economies these three transmission channels have to be supplemented with an *exchange rate channel* that is based on the purchasing power parity theory."

[12] Credit targeting is advisable as a temporary solution in situations of balance of payments crisis.

The *quantity theory channel*, developed during the period of the metallic standard (gold and silver era), postulates a very simple relationship by which an increase in money supply automatically induces an increase in macroeconomic demand. The relationship is nowadays evident in situations when central banks finance governments' expenditures by raising their monetary base and thus money supply which, in turn, increase inflation. Because of its neoclassical background, however, the quantity theory is unable to deal with macroeconomic demand and supply disturbances. It, nevertheless, offers a basis for a monetary targeting and medium-term oriented stabilisation programmes in high-inflation countries based on a calculation of maximum size of the deficit "that is compatible with a return to price stability" (Bofinger, 2001, p. 79).

Monetary targeting is a medium-term approach based on a simple cue assuming raise/reduction in short-term interest rates in face of raise/reduction in monetary growth. In this, money appears to be a straightforward nominal anchor. The approach relies on the basic assumption that the stock of money determines the aggregate level of nominal spending and that money demand is thus *controllable*. The supply of money is then steered based on projections of money multiplier, velocity of money, real output growth and inflation rate. The targeted monetary aggregates are usually set annually.[13] Successful monetary targeting, nevertheless, is preconditioned by a *stability* of short-terms relationship between money demand and price levels that is usually unlikely to be observed in countries facing financial deregulation and capital liberalisation such as transitional countries.

Exchange rate targeting as a prominent targeting option was established in many European countries in the aftermath of the Bretton Woods system during the 1970s. The approach is associated with a number of preconditions, which need to be met if the benefits of applying this approach are to materialise. These preconditions, according to Houben (2000, p. 91), hinge upon the general optimum currency area considerations, i.e. upon the existence of similarities in economic structures, economic shocks and policy preferences between the anchor and anchoring country.

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[13] Interestingly, even though the ECB did not adopt the monetary targeting, the ECB produces annual calculations of its reference value for the broad monetary aggregate M3 that is compatible with the price stability over the medium-term (ECB, 2004, p. 56).

In a modern world, *inflation targeting*, aims at stability by inaugurating inflation *forecast* for an effective nominal anchor placed at the end of the monetary transmission process. The most obvious advantage of inflation targeting is that it establishes a clear hierarchy of objectives and that it does so in a rather transparent manner. The result is increased visibility and predictability of monetary policy, which in turn raise the accountability of the central bank pursuing such targeting option. Most importantly, however, is that monetary authority aiming at inflation stabilisation in the context of inflation targeting thoroughly assesses all available information and indicators of future price developments. At the same time, nevertheless, such methodical approach requires vast resources and poses the question of who is producing inflation forecasts (central banks *vs.* professional institution) and whether those forecasts are open to manipulations. Moreover, the information, although easily communicable, are also very complex and thus require an additional effort from the central bank to engage in pedagogical activities.

As it will be explained in more detail in the following section, Serbia has targeted exchange rate traditionally and officially. The literature and the information which we collected while interviewing members of the NBS's highest decision making body, however, point to the fact that this may currently not be the case. Namely, the NBS has for some months now targeted both inflation and exchange rate. The current monetary framework may, therefore, be treated as the implicit inflation targeting. We believe, though, that such situation is not sustainable as it produces a lot of confusion to the market participants. If we add to this inadequate exploration of modern central bank's concepts like transparency in daily NBS's operations (see Chapter V), we may conclude that the entire NBS' monetary strategy should be revised.

In fact, all transitional countries of Southeast Europe are advised to rethink their current monetary strategies and understand necessary changes, which they may need to undertake in the course of alignment with the best European practices. But, in order to assess whether the proposed targeting and exchange rate options are compatible with the formal convergence criteria (the Maastricht criteria) one must firstly scrutinise the E(M)U institutional requirements contained in the primary and secondary sources of the EU legislation. Transposition of the EU legislation into the domestic legal system is a condition *sine qua non* for all those countries wishing to become the EU members.

4.3. E(M)U As An External Policy Anchor

The countries of the Western Balkans, including Serbia, have declared the EU membership to be their strategic goal. Consequently, the EU has become an external policy anchor for those countries.[14] The EU itself also has demonstrated its strategic interest in the Western Balkans, as its immediate neighbouring area. Herein, the peace and stability of the region appear to be the main political motives shared by both sides. On the other hand, the economic motives differ and for the Western Balkans include the economic reconstruction, development and real convergence in terms of income per capita *vis-à-vis* the current EU members. For the EU, the economic incentives are rooted in the prospective increased market space and expansion of mutual trade.[15]

However, EU membership is a distant reality. This is so not only because the EU itself has to learn how to cope with the ten new members, which is an argument put forward quite often lately. Namely, the process proved to be the lengthy one for the ten new members during their accession as well. Essentially, this is so because the European accession is a rather complex undertaking, requiring years of systemic alignment with 'European values'. Additionally, for all the former centrally planned economies, the integration with the EU coincides with the process of transition towards the market-based economic setting which, as we have seen earlier, has its own postulates.

The successful transition and the EU membership, thus, represent a confirmation of a cleverly applied combination of autonomous prioritisation of national political and economic objectives and the EU accession requirements. In other words, we argue that the principles and rules of the European integration process should be seen as means, not ultimate goals, but that, nevertheless, they have to be acknowledged by the Western Balkan countries sooner, rather then later.

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[14] In the foreword of Lopandić's work (2001, p. 13), Jelica Minić notes that "[t]he region of South Eastern Europe is not a *policy maker* on a European or a world level, but rather a *policy taker*". The ruling of Slobodan Milošević in Serbia during the 1990s clearly demonstrates that this is not necessarily so. Therefore, besides an argument implying that the policy of the great political and economic world powers is imposed (transposed) on smaller countries, there is also a clear need for those countries to embrace those policies internally if the 'policy taker' argument is to hold firmly.

[15] One should understand that the regionalisation in this respect plays a great role. Analysed separately, the countries of the Western Balkans are relatively small in size and their economic potentials are, thus, limited. Joint together, however, as a region, they gain on attractiveness by representing a market of around 50 million consumers.

Serbia affirmed its European determination by the adoption of the Resolution on European Integration[16] and the National Strategy for European Integration. The Strategy, nevertheless, discloses that this determination is abstract as it is based on a limited knowledge about the essence of both the accession process and the social consequences, which it produces (Government of the Republic of Serbia, 2005, p. 6). We find that this is so at least because of the following two reasons. Firstly, the politicians in Serbia debate about the issue of the EU accession almost exclusively within the context of electoral campaigns, both ongoing and perceived. Secondly, the political and economic circumstances (e.g. unclear prospects of the State Union SCG, hardship of the economic transition) do not themselves facilitate the mobilisation of all social actors in this process. Consequently, the issue of Serbia's integration into the EU is often overlooked or over-simplified. The purpose of our analysis here is to contribute to a better understanding of the requirements of accession process in the area of *monetary integration.*

4.3.1. EMU acquis communautaire

As explained in the introductory chapter, the full EU membership is condition by the fulfilment of Copenhagen criteria, which – among other things – assume the ability of a future EU Member State to undertake the obligations of membership. In practice, this means that any prospective EU Member State will have to comply with the Community's legislation (i.e. *acquis communautaire*). The process of the adoption of acquis is gradual and it takes place, almost exclusively, prior to membership through the so-called negotiating process. Membership negotiations are split into 31 chapters, each of which relate to a specific area of community law.[17]

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[16] The Resolution on European Integration was adopted by the Serbian parliament in December 2004.

[17] The Chapters include the following areas: (1) Free movement of goods, (2) Freedom of movement of persons, (3) Freedom to provide services, (4) Free movement of capital, (5) Company law, (6) Competition policy, (7) Agriculture, (8) Fisheries, (9) Transport policy, (10) Taxation, (11) Economic and monetary union, (12) Statistics, (13) Employment and social policy, (14) Energy, (15) Industrial policy, (16) Small and medium-sized enterprises, (17) Science and research, (18) Education and training, (19) Telecom and information technology, (20) Culture and audiovisual policy, (21) Regional policy and co-ordination of structural instruments, (22) Environment, (23) Consumer protection, (24) Justice and home affairs, (25) Customs union, (26) External relations, (27) Common foreign and security policy, (28) Financial control, (29) Finance and budgetary provisions, (30) Institutions, and (31) Other (see European Commission, 2003).

There does not exist a clear demarcation line between the chapters as the regulations covered by various chapters are mutually reinforcing and in most cases cannot be applied independently. This proves to be the case with the acquis covered by Chapter 11, which relates to economic and monetary union, and Chapter 4, which regulates the free movement of capital. Moreover, according to the European Commission (2003), the participation in EMU presupposes the adoption of the Single market acquis and in particular the acquis on free movement of capital. This is so because "monetary integration has two essential components: an exchange rate union and capital (*K*) market integration" (El-Agraa, 2001, p. 124).

With regard to capital mobility (Chapter 4), the evidence from prior accessions points to the fact that several candidate countries (now the EU Member States) have requested and were granted transitional periods (5-12 years) on foreigners' rights to invest freely in real estate in those countries. Nevertheless, they had to comply with the rest of the Chapter 4 acquis upon the date of accession. As already explained in Chapter II of this thesis, the situation in the case of acquis covering economic and monetary union (Chapter 11) is somewhat different. Namely, according to the Treaty Establishing the European Community (thereafter: the Treaty)[18], an EU Member State is either a Member State that has adopted the euro or a Member State with a *derogation*. All new Member States entered the EU with the derogation, meaning that none of them embraced the euro upon the date of accession to the EU. As in the case of Chapter 4, the new Member States had to comply with the rest of Chapter 11 acquis upon the accession date.

The requirements of Chapter 4 swings around Art. 56 to 60 of the Treaty (see Box 4.1) prohibiting all restrictions on capital movements amongst the EU Member States, and between the Member States and the third countries (i.e. *erga omnes* liberalisation). Besides the relevant Treaty provisions the Council Directive 89/361/EEC[19] and the relevant rulings of the European Court of Justice (ECJ) also regulate capital movements (short-, medium-, and long-term capital movements). This directive represents a decisive reaction of the EU authorities to liberalise capital movements from 1988 onwards, after the initial liberalisation of early 1960s failed to achieve this goal.

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[18] Official Journal of the EC, C 325, pp. 33-184.
[19] Official Journal of the EC, L 178.

Box 4.1. *The Treaty Establishing the EC, Chapter IV: Capital and payments*

CHAPTER 4
CAPITAL AND PAYMENTS

Article 56

1. Within the framework of the provisions set out in this chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.
2. Within the framework of the provisions set out in this chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited.

Article 57

1. The provisions of Article 56 shall be without prejudice to the application to third countries of any restrictions which exist on 31 December 1993 under national or Community law adopted in respect of the movement of capital to or from third countries involving direct investment — including in real estate — establishment, the provision of financial services or the admission of securities to capital markets.
2. Whilst endeavouring to achieve the objective of free movement of capital between Member States and third countries to the greatest extent possible and without prejudice to the other chapters of this Treaty, the Council may, acting by a qualified majority on a proposal from the Commission, adopt measures on the movement of capital to or from third countries involving direct investment — including investment in real estate — establishment, the provision of financial services or the admission of securities to capital markets. Unanimity shall be required for measures under this paragraph which constitute a step back in Community law as regards the liberalisation of the movement of capital to or from third countries.

Article 58

1. The provisions of Article 56 shall be without prejudice to the right of Member States:
(a) to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested;
(b) to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.
2. The provisions of this chapter shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty.
3. The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56.

Article 59

Where, in exceptional circumstances, movements of capital to or from third countries cause, or threaten to cause, serious difficulties for the operation of economic and monetary union, the Council, acting by a qualified majority on a proposal from the Commission and after consulting the ECB, may take safeguard measures with regard to third countries for a period not exceeding six months if such measures are strictly necessary.

Article 60

1. If, in the cases envisaged in Article 301, action by the Community is deemed necessary, the Council may, in accordance with the procedure provided for in Article 301, take the necessary urgent measures on the movement of capital and on payments as regards the third countries concerned.
2. Without prejudice to Article 297 and as long as the Council has not taken measures pursuant to paragraph 1, a Member State may, for serious political reasons and on grounds of urgency, take unilateral measures against a third country with regard to capital movements and payments. The Commission and the other Member States shall be informed of such measures by the date of their entry into force at the latest. The Council may, acting by a qualified majority on a proposal from the Commission, decide that the Member State concerned shall amend or abolish such measures. The President of the Council shall inform the European Parliament of any such decision taken by the Council.

Source: Official Journal of the EC, C 325, pp. 56-57.

An instructive overview of relevant Treaty provisions mentioned above is provided by Craig and De Búrca (2003). Importantly, the authors note that those provisions, in fact, do not supply the definition of capital movements, implying that the ECJ is called for to decide – based on the Directive 89/361/EEC – whether a particular measure restricts the movement of capital. Hitherto, it appears that the ECJ had been interpreting those articles rather restrictively; the strictness being evident both in application of articles setting up the basic principles relating to the capital movements and in employment of articles carrying exceptions.

Notwithstanding the significance of acquis regulating the area of free movement of capital directly and unswervingly – due to its connectivity to the regulation of financial sector (banking, insurance, financial markets, etc.) and related activities such as the payment system operations, accounting and auditing, prudential supervision, and money laundering – those elements must be considered concurrently. Starting from this position, we note that Serbia's achievements in relation to the capital account liberalisation are unsatisfactory mainly due to the fact that a complete financial infrastructure does not exist yet. The Serbian National Strategy for European Integration recognises this fact. It is, thus, not surprising that the Strategy itself steps out of the limits of a general strategic document by setting a quite detailed action plan of necessary activities.[20]

This feature also reveals an obvious attempt of the Serbian government to overcome the problem of non-existence of adequate national development strategy through the adoption of the National Strategy for European Integration. The implications of this approach are such that the existing Strategy fails to offer answers to the questions relating to the pace and sequencing of capital account liberalisation (gradual *versus* big bang) in relation to the EU accession, which should be its primary task. That Serbia is still at the very early phase of financial transition is confirmed by the exact fact that the Strategy is actually setting the preconditions of a functioning financial market, without any substantial reference to the liberalisation of that market. In such circumstances, the only sensible straightforward policy recommendation would be for Serbia to complete the financial regulatory framework without any additional delay.

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[20] The Strategy suggests that the following laws are adopted: Law on Investment Funds, Law on Electronic Payments, Law on Supplementary Protection of Payment Transactions, Law on Protection of Small Investors, and Law on Protection of Bank Deposits (Government of the Republic of Serbia, 2005, p. 153).

The acquis relating to the Economic and Monetary Union (Chapter 11) includes the basic principles underlining the Treaty. In particular, Article 2 of the Treaty defines the general *economic policies* of the Community, whereas the Article 4 envisages the adoption of an economic policy of close coordination among Member States based on irrevocably fixing of the exchange rates and promotion of principles of stable prices, sound public finances and monetary conditions, and a sustainable balance of payments. The Treaty further prescribes that the economic policies should be regarded as a matter of common concern (Article 99); it prohibits direct financing of the public sector by central banks and of privileged access of the public sector to financial institutions (Art 101 and 102), and imposes the obligation upon the Member States to avoid excessive budget deficits (Article 104).

With relation to *monetary policy*, the Treaty prescribes the maintenance of the price stability as the primary objective of ESCB and defines its other rights and duties (Article 105). Article 107(1) specifies ESCB membership, while Art. 109 and 116(5) envisage the independence of all national central banks. Moreover, the Treaty instructs each Member State to treat exchange rate policy as a matter of common interest (Article 124). Article 121 and Protocol 21 of the Treaty define the criteria, which must be met by a Member State before it can adopt the single currency, the euro. Member States that do not fulfil the criteria are referred to as 'Member States with a derogation' (Article 122(1)).

In practice, the derogation implies that the rights and obligations defined by Article 43 of the Statute of the ESCB as given in the Protocol 18 of the Treaty and Treaty Article 104(9,11) about the procedure for giving a Member State formal notice to reduce its budget deficit and the possibility for the Council to impose financial and other penalties on Member States which persistently fail to comply, are temporarily suspended. On the other hand, only those Member States with the derogation may benefit from a facility providing medium-term financial assistance for Member State's balance of payments in line with the Council Regulation 2002/332/EC[21] and the European Central Bank Decision ECB/2003/14[22].

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[21] Official Journal of the EU, L 53, and L 349 (corrigendum).
[22] Official Journal of the EU, L 297.

Institutional implications of the Treaty provisions relating to the length of the terms of central bank governors, prohibition for a central bank to take any instructions from government, objective to maintain the price stability and prohibition of lending by the national central banks to governments are of special importance for our study. We believe that those considerations are likely to induce further alterations to the institutional framework of the National Bank of Serbia in a foreseeable future and Chapter V of this thesis, therefore, investigates those issues in more detail. In this context, we shall also engage in elaboration of necessary actions, which Serbia's institutions need to conduct to prepare themselves for economic policy coordination and surveillance, compliance with the broad economic guidelines reporting, and possible usage of excessive deficit financial assistance procedures that become effective as of the date of the EU accession.

As an EU member, each country is instructed to treat its exchange rate policy as a matter of common interest in line with the Article 124 of the Treaty. Moreover, each Member State that wants to adopt the euro must, among other things, operate its exchange rate policy under the framework of the so-called Exchange Rate Mechanism II (ERM II) for at least two consecutive years, although the decision about the participation in ERM II itself is a voluntary. The bilateral central rate against the euro is determined jointly by the Finance Ministers of the euro area countries, the ECB and the Finance Minister and Governor of the non-euro area country participating in ERM II. ERM II mechanism aims to contain the oscillations of the participating currency within the agreed bands (maximum ±15 per cent) *vis-à-vis* the central rate without the possibility of devaluation for at least two years before the assessment about the fulfilment of the Maastricht criteria takes place.

The ERM II is seen as "a training room prior to irrevocably fixing of exchange rates" (Banque de France, 2004, p. 5) with a strong multilateral and cooperative dimension that exists between the central banks involved. Also, ERM II is viewed as a phase in which the credibility and sustainability of pursued policies are tested. Since those are not the attributes that can be obtained over-night, the candidate and association countries have started their search for a right monetary and exchange rate policy mix well before the actual E(M)U membership. The conducted literature review reveals that the currency board arrangements and euroisation are, in fact, the two most debated options.

4.3.2. Currency board arrangements (CBAs)

Why are the currency board arrangements seen as one of the main modules in fulfilling ERM requirements? It is our firm belief that the answer to this question is identical to that responding to the query of what has initiated the revival of the CBAs during the 1990s.[23] The simple reply is the search for the *credibility* and *stability* in monetary policy matters. The primary goal of the currency board arrangements, back in the 19th century when they were first established, however, was far more lucrative (although, this is not to say that the credibility and stability of monetary policy are secluded from any money-spinning activities at its far end). Namely, the conventional mantra stipulates that the CBAs came into existence during the colonial period and that the first CBAs were placed in the British colonies[24] with the view to economise on transport costs and to allow local governments benefit from seigniorage. The context of those currency boards, therefore, significantly differs from the CBAs of modern times.[25]

Nowadays, a currency board arrangement in its pure sense "can be defined as a monetary regime based on an explicit legislative commitment to exchange domestic currency for a specified foreign currency at a fixed exchange rate, combined with restrictions on the issuing authority–the currency board–to ensure the fulfilment of its legal obligation" (Baliño and Enoch, 1997, p. 1). In other words, the currency board is meant to be a rather strict rule-based monetary arrangement. Over time and due to country specific circumstances under which the CBAs were introduced, the rigorousness was somewhat lost. In some cases, this did not happen at expense of CBAs' credibility, but rather introduced more flexibility into the operations of CBAs and has relaxed the procedures in the so-called 'exit strategy' scenarios. Still, in many aspects, the CBAs do resemble the characteristics of standard fixed peg arrangements. What is different is a clear legal commitment – existing under the currency board arrangements – not to alter the exchange rate.

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[23] Here, we have in mind the CBAs established in Argentina (1991), Estonia (June 1992), Lithuania (1994), Bosnia and Herzegovina (June 1997) and Bulgaria (July 1997).

[24] The very first currency board was introduced in Mauritius in 1849 (Baliño and Enoch, 1997, p. 1).

[25] According to Baliño and Enoch (1997, p. 1), "[t]he degree of capital mobility during the colonial period was limited, and most colonial governments lacked fiscal independence. Moreover, the banking systems of these colonies consisted of foreign banks that relied on their headquarters for liquidity support and interbank settlements."

The adoption of a currency board requires that a law is passed stipulating the fixity of the exchange rate and the foreign exchange reserves necessary to cover the domestic liabilities. Although there is a possibility for the authorities wishing to implement a CBA before the law is passed to do so by operating a *quasi-CBA*, this should only be regarded as a transitory solution while the law is actually adopted. The law enactment, however, takes time and so it is important that thorough preparations take place well in advance. This is so because, apart from the time-consuming procedural and political nitty-gritty that surround the endorsement of any law by a parliament, there is a more fundamental issue of reaching the national consensus and informing the general public and media of the intention to adopt such a specific rule-based regime (see Enoch and Gulde, 1997).

In extreme situations, the provisions defining the scope of a currency board arrangement may even be included in a country's constitution, which places additional time and political pressure on the authorities. Even though this will tend to increase the public confidence in the authorities' decisiveness to maintain the CBA, it will further constrain the practical CBA management *via* reduced flexibility. The same stands true for any overly detailed law establishing a CBA such as the prohibition to finance government. Depending on the country specific characteristics and aims, which the authorities want to achieve, this law may also specify the terms under which the exchange rate peg *may* be changed. This, however, may seriously undermine the credibility of the currency board even before it is introduced. Just a possibility that the authorities may wish to step back from its initial commitment may lead the public to believe that they are not ready to firmly defend the chosen monetary regime and, thus, that the regime is not credible.

Conceptually, thus, we may say that there is an obvious trade off between the increased transparency in operating a CBA and the accompanying increased credibility, on the one hand, and the loss in flexibility of a CBA, which in itself may weaken the above mentioned credibility, on the other hand. Therefore, the authorities may trade those legal provisions for more credibility by simply leaving them out of the law. This is of particular importance having in mind that the crux of CBAs lies in their ability to reduce discretion of monetary authorities by imposing on them rather strict 'backing rules'.

'Backing rules' specify restrictions on currency issuance *vis-à-vis* the level of defined foreign exchange reserves, which have to be implemented continually. Herein, both the composition of foreign exchange reserves as well as the definition of domestic monetary liabilities that are to be backed must be specified. The foreign exchange reserves may be set either on a net or on a gross basis and may or may not include the IMF and other long-term borrowings. In its narrowest form, the CBAs are designed in a way that the entire monetary base (M0) is covered by the central banks' net foreign assets (NFA). However, as evidence confirm, this rigid rule is often disobeyed (see Baliño and Enoch, 1997). Although, in principle, the backing rule is determined on a case-by-case basis, the adoption of a CBA presupposes existence of a high level of forex reserves.

The issue is also connected to the question of selection of a peg currency. Enoch and Gulde (1997) advise that a peg currency be a stable currency of a country with the sound financial system and long record of low inflation. The authors also point to the fact that the actual and potential trade flows are also taken into account when deciding about to which currency to peg. Besides, they propose that the level of 'dollarisation', that is, the usage of another currency in the country opting for CBA, is also considered before announcing the decision. Ultimately, the question of designated reserve structure during the CBA operation is influenced by the composition of international reserves prior to the CBA inauguration. Here, it is recommended that a country opting for a specific peg currency also ensures that a major part of its international reserves (around 80 per cent[26]) is held in the peg currency by the time of the start of the CBA.

On the other hand, according to Enoch and Gulde (1997, p. 6), "the specified domestic monetary liabilities can comprise reserve money, or domestic liabilities of the central bank". At minimum, however, the designated monetary liabilities should include currency in circulation and banks' deposits at the central bank, but may also include other central bank's short-term liabilities. It would be important, though, both from the psychological and economic point of view, for a central bank to ensure that the supply of adequate quantities of banknotes is available and that appropriate storage and transport facilities are put in place in time for the start of the CBA, bearing in mind potential large costs of these operations.

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[26] The figure is put forward by Enoch and Gulde (1997, p. 19).

Backing and exchange rate rules are obviously a country specific question, but the authorities crafting a CBA should abide by the universal principles of simplicity and transparency. These two principles aim at securing the overall credibility of the CBAs, as earlier explained. The credibility of the CBAs will also be underpinned if the banking system went through a broad-based restructuring prior to the start of CBA operations. This is especially important having in mind one of the main features of the CBA, that is, the restriction in terms of lending to banks (lender-of-last-resort function). As a matter of fact, the lending to banks under the CBAs is permitted if excess reserves are accumulated. This, in turn, requires that the inter-bank markets, which take on a crucial role under the CBAs, are institutionally and operationally strengthened before the CBA regime is established. The same applies to the banking supervision.

Similarly, if the CBAs are to make sense and offer full benefits, a sufficient degree of countries' openness in terms of trade and capital flows must be provided. Namely, as pointed out in Chapter II, Bofinger and Wollmershaeuser (2000) stress that the CBAs are only advisable for very open economies with the ration of openness higher then 72.5 per cent. The idea behind such statement is that only open CBA economy with no or with fewer restrictions on capital movements may benefit from interest equalisation taking place in international setting, i.e. between the CBA country and the country of the peg currency, which is a strong motive for a CBA introduction in itself.

A major drawback of the CBAs, besides the one relating to the loss of classical central bank functions (e.g. monetary management or lender-of-last-resort function), derives from the rigidity that is inherited into the system of CBAs. This question is also linked up with the issue of CBA duration and resulting 'exit strategy' problem. Baliño and Enoch (1997) stress the need for the authorities to decide on whether a CBA is a transitory or long-term/permanent solution. If the former is the case, then the exit strategy may assume gradual relaxation of rigid rules or it can happen 'under stress' due to a large external shocks once they occur. In this, a country may be put under the pressure to appreciate or depreciate, or may decide to switch to another peg currency or to altogether switch to a floating regime. If, however, a CBA is deemed to be a longer-term policy options, then the accompanying structural reforms (e.g. fiscal policy and labour markets) must take place in order to allow more flexibility to enter the system.

Interestingly, however, none of the modern currency boards had predefined their exit strategies as of 2000 (Gulde, Kähkönen and Keller, 2000, p. 16). Nevertheless, the new EU member countries (Estonia, Lithuania), as well as acceding country (Bulgaria) operating CBAs and wishing to adopt the euro, started scrutinising their monetary and exchange rate regimes as early as several years prior to their accession to the EU. The two main questions they posed are: (1) can a CBA be seen as a regime compatible with the Maastricht requirements, which need to be fulfilled in the period preceding the euro adoption, and (2) are the CBAs as such compatible with the participation in ERM II.

The analysis performed by Gulde *et al.* (2000) reveals that, in principle, the CBAs are compatible with the formal requirements alongside with a variety of other exchange rate regimes. Officially, the European Central Bank confirmed its consent with such stance in late 2003, as mentioned in Chapter II. The position is built on the evidence pointing to the fact that the macroeconomic stability, as requested by the Maastricht criteria, has been achieved in the countries operating the CBAs. Most remarkable is the low inflation record, which did not happen at the costs of output decline. Also successful were the countries operating a CBA in achieving the fiscal discipline and containing current account deficits. The authors, however, note that all this could have happened as a result of a 'rebound effect' (as many CBAs were establish after crisis took place) or 'self selection' (CBAs were in general established by pro-reformist governments) and not due to the CBAs, and thus recommend a dose of caution in interpreting the results.

More particularly, in relation to ERM II participation, the authors find that the main objectives (facilitation of nominal convergence towards the Maastricht criteria, allowing a market test for exchange rate stability, helping to ensure that countries enter the euro zone at an appropriate exchange rate, preparing central banks for operating within the euro zone) can be achieved under the CBAs (Gulde *et al.*, 2000, p. 17). This, in turn, means that countries operating CBAs would not necessarily have to switch to intermediate regimes prior to the euro adoption, but that they could continue applying the CBAs. Nevertheless, under such scenarios, the countries are likely to face several challenges such are large capital inflows and asymmetric shocks. To be able to respond adequately, therefore, they would need to maintain the policy discipline in a number of areas (fiscal policy, financial system, external debt, flexible labour markets, etc.)

4.3.3. Euroisation

A precise definition of 'euroisation', which in some parts of the world is dubbed 'dollarisation',[27] pretty much depends upon the extent of the domestic currency substitution and upon the degree of formality surrounding that process. The simplest definition is that euroisation occurs when a foreign currency replaces a domestic currency as a store of value, a medium of exchange, and/or a unit of account. In other words, euroisation assumes that people are using the chosen foreign currency in order to hedge against the exchange rate risks (i.e. domestic currency devaluation) and high inflation by diversifying their portfolio holdings.[28]

Depending on the degree of domestic currency substitution, the distinction can be made between the: (1) financial euroisation, (2) payments (currency) substitution, and (3) real euroisation. *Financial euroisation* occurs when the foreign currency takes over the domestic currency's function of a store of value (i.e. when residents hold their financial assets in foreign-currency denominated assets) and when the deposits are held in foreign currency (liabilities euroisation). *Payments euroisation* implies that the foreign currency assumed the role of a medium of exchange and is used by residents in wholesale and retail transactions instead of the domestic currency. *Real euroisation* takes place when domestic prices and wages are indexed to the exchange rate (IMF, 2005, p. 66).

Moreover, the distinction may be made between the (i) unofficial euroisation, when foreign currency is not declared as legal tender (also called '*de facto* euroisation' or bicurrency system), and (ii) official euroisation, when a foreign currency formally obtain the status of a legal tender in which case the domestic currency cease to exist.[29] Finally, in the context of European integration, the difference is made between the *unilateral euroisation*, and a *full EMU membership* reflecting the agreed adoption of the euro.

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[27] The notions euroisation and dollarisation are, in conceptual terms, synonymous. The difference arises from the specific currency underlining the process. Thus, euroisation assumes involvement of the euro, whereas dollarisation implies the usage of the dollar. Similarly, some authors refer to 'markisation' thereby stressing the supremacy of the deutsche mark over the domestic currency (see, for example, Gligorov, year not known).

[28] "[Euroisation] can be explained as a risk hedging instrument to limit the volatility of total returns in a multiple currency portfolio (Ize and Levy-Yeyati, 2005)" (IMF, 2005, p. 66).

[29] To this division, some authors (see Fabris *et al.*, 2004) also add the: (iii) official semi-euroisation, whereby both currencies, foreign and domestic, are used as legal tenders, and (iv) monetary union, which refers to a situation when several countries use a common currency such as the case with the EMU.

Due to the fact that euroisation and currency boards resemble similar characteristics, a number of scholars often debate about the two regimes in the same context (see, for example, Nuti, 2000, in Chapter II). Although we principally agree with such position, it is our view that one critical difference clearly separates the two regimes. Namely, the currency boards (including the quasi-CBAs) are always born out of a conscious decision of monetary authorities to impose a firm discipline and gain on monetary stability by providing a full foreign exchange backing for money circulating in the economy. On the other hand, unless it is formally embraced, euroisation reflects the rational reasoning of economic agents and the public at large about the necessity of attaining monetary stability (for) themselves. Even the official euroisation does not happen 'out of blue', but instead often results from *de facto* euroisation.

The motives for both adoption of CBAs and euroisation are thus arguably very similar in comprising of increased monetary stability and policy credibility. However, the *initial impulse* clearly comes from different sources; from the authorities in the case of CBAs and from the general public in the case of euroisation. This separation appears helpful in identifying the causes and consequences of any high euroisation, and especially its macroeconomic, prudential and policy implications. Herein, it is indubitable that initial euroisation "is a response to economic instability and high inflation" (Baliño, Bennett and Borensztein, 1999, p. 5). What is intriguing is that even *after* the stability is achieved and inflation drastically reduced, euroisation resides as the initial impulse of the general public to euroise does not fade. The view is strongly supported by evidence from many euroised countries (see Balino *et al.*, 1999), including Serbia. Why is this so?

One explanation, offered by Guidotti and Rodríguez (1992) and embraced by others[30], is 'hysteresis', which assumes that some form of irreversibility is built-in the process of euroisation. This component of consistency in usage of foreign currency most plausibly results from the convenience experienced by the economic agents and the fact that a switch to a domestic currency could only occur if: (i) accompanied by substantial benefits, and/or (ii) if faced with increasing costs of foreign currency holdings. An alternative or additional explanation is that the asset substitution increases due to the reversal of capital flight and remonetisation, as explained below.

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[30] See, for example, Baliño *et al.* (1999) and IMF (2005).

In order to reveal the mechanics behind the process of dollarisation (euroisation) and because of its obvious connection with monetary developments, Baliño *et al.* (1999) distinguish between the three types of foreign-currency-denominated assets: (1) foreign currency deposits (FCD) in the domestic banking sector, (2) foreign currency in circulation (FCC) within the domestic economy, and (3) cross-boarder deposits (CBD) held at banks abroad. They found that FCD constitute a significant share of broad money in several transition economies, reaching 30-60 per cent in early years of reforms. According to the authors, high inflation, negative real interest rates on assets held in domestic currency, and sharp devaluations (increasing the value of foreign-currency-denominated assets in domestic currency) all contributed to the increase in FCD ratio. The FCD ratio, however, sharply declined in several countries (e.g. Estonia, Poland) just after the effective price stabilisation.

Interestingly enough, the same did not happen to the dollarised Latin American countries. On a contrary, the FCD ratio further increased following the stabilisation. Apart form the hysteresis effect, the explanation seems to lie in the surge of capital inflows to developing countries. Namely, Baliño *et al.* (1999, p. 8) found that the increase in FCD ratio was taking place in parallel with the decrease in CBD, reflecting the raise in confidence of the domestic economy "(although not necessarily in the domestic currency)". The occurrence is assumed to be a part of a larger process of remonetisation of the domestic economy, as in the case of Serbia (see IMF, 2005).

Implications for monetary and exchange rate regimes in euroised economies appear to be rather substantial. In relation to exchange rate policy, the existing literature suggests that *currency substitution* tends to increase the volatility of a floating exchange rate because the demand for domestic money becomes more sensitive to changes in its expected opportunity costs (increased interest elasticity of domestic money demand). Depending on the shocks to which the country is exposed, however, the higher elasticity may also bring the opposite effects. Therefore, the case for fixing the exchange rate is not a clear-cut. "A clear case for fixing the exchange rate in a highly dollarized [euroised] economy is when stabilising from very high inflation or hyperinflation" (Baliño *et al.*, 1999. p. 14) due to which the prices are indexed to the exchange rate. Fixing the exchange rate, thus, serve to stabilise the inflation expectations.

Although the authors stress that the *asset substitution* does not directly affect a narrow definition of money demand, since the domestic currency deposits and foreign currency deposits became close substitutes, the link between the interest rates of foreign currency abroad and in euroised economy with interest rates on domestic currency strengthens as well. This, in turn, limits the central bank control over the domestic currency interest rates implying that a more flexible exchange rate may be more effective instrument in hands of monetary authorities. The difficulty with such conclusion is that it contradicts the general recommendations in the case of currency substitution. It is thus advantageous to know the exact extent of asset *and* currency substitution.[31]

Regarding the implications of euroisation on monetary policy, it is found that in a floating exchange rate regime, or a fixed exchange rate regime with limited capital mobility, euroisation indeed influences the choice of intermediate targets of monetary policy. What would be a right monetary aggregate to target in such circumstances is an empirical question depending on the asset composition of money demand in each particular euroised country. One broad observation, however, is that frequent revisions of intermediate target values would deem necessary whatever the chosen target. Analysis thus leads to the fundamental question of the usefulness of the monetary targeting strategy in case of euroised economies. It is true, though, that monetary policy can operate using various domestic or foreign currency instruments, but this assumes that a whole set of institutional and arrangements are put in place (payment system adjustments, central bank expertise, prudential bank supervision, etc.) before this becomes possible.

This is not to say that euroisation as such does not bear any *benefits*. On the contrary, euroisation is coupled with several positive occurrences such as higher financial intermediation, financial deepening, and increased credibility. Financial intermediation tends to increase with the reestablishment of macroeconomic stability and low inflation in an environment in which FCD are available and can be held at domestic banks. Allowing FCD also increases the credibility of the authorities to maintain financial stability by raising the stakes, but this still does not by itself rules out the possibility of crisis.

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[31] However, the measurement problems, especially in the case of currency substitution, happen to be rather complex. Baliño *et al.* (1999, p. 15), nevertheless, provide one general hint: "In this light, a potentially more fruitful approach to identifying currency substitution would start not with money demand but with the determinants of inflation".

And the risk of financial crisis is the main cause of concern and the major *drawback* associated with euroisation. The risks come mainly from two sources. Firstly, as it is the case in Serbia, the great euroisation of bank assets increases credit risks because of a simple fact that, while lending is indexed to the euro, the borrowers' wages and salaries are not. Furthermore, since the loans are extended on the basis of collateral an increased volatility of the exchange rate or a large devaluation of domestic currency would lead to credit crunch, forcing banks to improve the quality of their loan portfolios and increase provisioning.[32] In relation to this Baliño *et al.* (1999, p. 13) note the following: "In fact, the central bank may attempt to avoid significant devaluations because of the quality of the bank's loan portfolios, even if there were otherwise valid macroeconomic reasons to devalue", which will prove to be of particular importance for Serbia (see next section). In other words, euroisation may increase the 'fear of floating' (see Chapter III) and thus limit the exchange rate policy preferences.

Secondly, the high liability euroisation exposes banks to systemic liquidity risks, as foreign currency deposits are not fully covered by liquid foreign currency assets. Thus, unless the banks have available liquid CBD, they may run out of foreign currency reserves in face of unexpected disturbances. Furthermore, this increases the pressure on the central bank to build large foreign currency reserves in order to be able to bail out the banks in case of sudden shifts in capital outflows. The question of constrained central bank's function of the lender-of-last-resort in the case of partial euroisation and the complete loss of that function in the case of full euroisation is, however, possibly somewhat exaggerated.[33]

Finally, at the top of this list of costs of euroisation, there comes the loss of seigniorage, as euroisation reduces the demand for domestic currency.

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[32] The deterioration of banks' financial position is less likely if a large share of foreign-currency-denominated loans is extended to those debtors whose net financial position benefits from devaluation, such are exporters (Baliño *et al.*, 1999, p. 13).

[33] Interestingly, the participants to the panel about euroisation (the National Bank of Serbia Governor Radovan Jelašić, the National Bank of Slovakia Governor Ivan Šramko, and the National Bank of Croatia Deputy Governor Boris Vujčić), which was held in Belgrade in May 2005 during the Annual EBRD Conference, expressed the view that the concept of the 'Lender-of-Last-Resort' is in a way outdated. The main argument behind such statement is that, in real life, a central bank may attempt (and shall hopefully succeed) to bail out one bank if in crisis, but that it is very unlikely that the central bank will be able to do the same for all the banks in view of a systemic banking crisis. The problem also arises from the fact that no clear line can be drawn between s single-case and a systemic banking crisis taking place.

Altogether, the case for euroisation shrivels together with its costs. Therefore, the next question to be posed is how to reduce those costs. The answer, in principle, depends on whether the authorities want to totally reduce or to contain euroisation. Generally speaking, there are measures that would assume the use of: alternative financial instruments, policies that create an interest rate wedge, direct restrictions on foreign currency deposits, or measures to encourage the use of domestic-currency-denominated cash. It is, however, beyond the scope of this thesis to explain each of them in detail.

One alternative approach, which appears especially appealing to countries involved in the process of European integration, is to euroise officially, though unilaterally, prior to obtaining a full EMU membership. In this context, Coricelli (2002), who investigates the issue on the sample of several CEE countries, finds that the significance of real or structural factors is exaggerated and that financial factors play a much more important role. Namely, it is evident that transition countries typically register faster growth rates then the EU Member States, large current account deficits implying accumulation of foreign debt, and large stocks of foreign currency deposits. These underlining macroeconomic fundamentals happen to expose countries to the adverse effects of exchange rate swings. Herein, a sufficient exchange rate flexibility has two main justifications: (1) Balassa-Samuelson effect implying real appreciation of the exchange rate, and (2) opportunity to test the equilibrium exchange rate over time.

Coricelli (2002), however, finds both arguments to be rather weak on the grounds that the exchange rate flexibility in transition countries also tends to be associated with high interest rate spreads, high real interest rates, and vulnerability of the domestic economy and the financial sectors to external shocks. On the other hand, the case for the early adoption of the euro strengthens as EU membership approaches because the transition countries become more open, strengthen their trade relations with the EU and increase the flexibility of their labour markets during the accession process. The analysis suggests that with the adoption of the euro further convergence will take place, permitting an immediate elimination of the interest rate premium and the reduction of real interest rates. Besides, with the capital liberalisation (part of EU acquis) "the adoption of the euro would eliminate the vulnerability of those countries to sudden shifts in capital flows, and their disruptive effects on the domestic financial sector" (Coricelli, 2002, p. 412).

4.4. Serbia's Framework for E(M)U Membership

How do all these considerations relate to Serbia? Is it premature for Serbia to start thinking of a relatively distant EMU membership? When is a good time to start? What approaches are available? Those are some of the questions that are, for the time being, only sporadically raised within the narrow circle of Serbian economists. A wide public debate has not been initiated so far. In this respect, an inhibiting attitude of the authorities *vis-à-vis* those issues, is not encouraging either. But, what are the reasons behind such behaviour?

The most likely explanation is that the real fundamentals in Serbia have still not been fully stabilised. This is understandable. The transition in Serbia is yet far from being complete. It is, thus, comprehensible that immediate concerns over the regular and anticipated revisions of conditioned arrangements concluded with the IMF are the main preoccupation of the Serbian politicians.[34] Comparing to this, a non-contractual relationship with the EU does not stand a chance and, consequently, does not bear a priority status. Besides, the Serbian National Strategy for European Integration was only adopted in July 2005.[35]

The purpose of this section is to encourage the debate about the EU-related issues. For that purpose, the section depicts the structural and monetary characteristics as well as the rudiments of Serbia's monetary and exchange rate regimes in the period of the last fifteen years (1989-2004), leaning on the main findings of Chapter II and Chapter III. The overview of historical monetary and exchange rate modes should allow us to sketch out the alternative policy choices Serbia is likely to face in the run-up to E(M)U.

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[34] A political debate surrounding the privatisation of the Serbian state-owned oil and gas company *Naftna Industrija Srbije* (NIS) may serve as an illustration. The initiation of NIS privatisation was one of the conditions for conclusion of the Sixth Review under the Extended Arrangement with the IMF. A delayed compliance with this condition noted in the IMF letter to the Serbian Prime Minister Vojislav Koštunica in mid-August 2005 caused a real turmoil at the Serbian political scene. Being put under the pressure, the Serbian government launched the process of selection of NIS privatisation adviser on 18 August 2005. However, the Law on NIS (Official Gazette of the RS, No. 37/91), which needed to be revoked by the Serbian parliament in order to allow the company restructuring prior to privatisation, caused the members of the Social-Democratic Party (*Socijaldemokratska Partija-SDP*) to leave the ruling government coalition. The parliament eventually revoked the Law on 22 August 2005.

[35] The Government of the Republic of Serbia adopted the" National Strategy of Serbia for Serbia and Montenegro's Accession to the European Union" on 17 June 2005. The Strategy was also formally endorsed by the Serbian Parliamentary Committee for European Integration on 12 July 2005.

4.4.1. Serbia's monetary and structural characteristics

Here, several studies of varying time-spans appear relevant. The main question in SFR Yugoslavia during the 1960s, 1970s and 1980s was whether the money supply was indeed endogenous, i.e. was it simply accommodating enterprises' needs in periods of price pressure resulting from supply side forces, or was the National Bank of Yugoslavia actually affecting real output. Chowdhury, Grubaugh and Stollar (1990, p. 643)[36] found for the period covering the last quarter of 1964 to last quarter of 1986 that money in SFR Yugoslavia did not "cause industrial production" and that "the money supply was endogenously determined".[37]

The issue during the 1980s, when inflation in the SFR Yugoslavia started spurring, was to establish the functions of money demand and supply. For that purpose, Petrović (1995) developed a money demand model where real money holdings depend on the expected price level and the expected real exchange rate. For the period *January 1980-November 1989*[38], the study reveals that the broad base money – which included both the dinar component of base money (currency in circulation and bank reserves) and foreign currency liabilities to commercial banks – did generate Yugoslavia's high inflation in the 1980s, whereas the dinar component only accommodated it.

Herein, Petrović (1995, p. 47) establishes that broad money was co-integrated with prices as "prices caused money and money caused prices" and that the narrow money was cointegrated with prices and exchange rate in a way that "they caused narrow money, while narrow money did not cause them". Moreover, a conclusion emerged that the exchange rate losses in the form of quasi-fiscal deficits borne by the NBY were the main driving force behind the broad money expansion that fuelled inflation. Therefore, the exchange rate losses appeared to drive the Yugoslav inflation in 1980s, as suggested by Lahiri (1991) that we introduced in Chapter III.

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[36] In their study, interestingly, Chowdhury *et al.* (1990, p. 640) chose Greece and Spain "for comparison since they are economies at a comparable stage of development [...] and of a similar size" to Yugoslavia.

[37] According to the authors, the two reasons may have laid behind this: (1) the NBY was not pursuing an active monetary policy, and (2) the NBY was unwilling to let any enterprise fail by declining them credits. Those findings led authors to conclude that the combination of a market economy and socialism such existed in SFRY (see Chapter III) may not be compatible with an effective monetary policy.

[38] This is a period preceding the introduction of the 'Marković's programme', which was initialled in December 1989, as explained in Chapter III.

Petrović and Vujošević (2000) further looked at peculiarities of monetary accommodation in SFR Yugoslavia *during the 1980s* and found that other then the quasi-fiscal deficits resulting from exchange rates losses, the monetisation of quasi-fiscal deficits induced by the excessive wage demands had an equal share in perpetuating the Yugoslav high inflation. In other words, the authors documented that the money was co-integrated with wages, not with prices, and that the aggregate supply shocks (i.e. those to wages and prices) and exchange rate shocks were driving inflation, whereas the impact of money supply shocks was transient. The accompanying conclusion was that the Yugoslav inflation was not driven by excessive government deficit.

Sharpening the focus on the dynamics behind the inflation in Yugoslavia during the 1980s, Juselius and Mladenović (2002) confirmed empirically that the inflationary expectations over nominal wage claims as well as the expectations about the depreciation of black market exchange rate also played a role in spiralling inflation. In summing up, Juselius and Mladenović (2002, p. 26) noted: "The underlying cause of the ever increasing inflation rate seems to be in the financing of excessive wage claims with cheap bank credit based on currency deposits, with consequent currency depreciation, and increasing prices".

Petrović, Bogetić and Vujošević (1999) analysed the causes, dynamics and money supply process in the FR Yugoslavia during the hyperinflation (*1992-1994*). As it was explained in Chapter III, the authors found that hyperinflation was driven by excessive money supply through monetisation of various deficits. The money growth was found to be weakly exogenous, affecting inflation *via* currency depreciation and suggesting high indexation of prices to exchange rate movements. Petrović *et al.* (1999, p. 335) concluded that this resulted in the NBY's loss of control over the money supply.

Additionally, Petrović and Mladenović (2000) discovered, in relation to Yugoslav hyperinflation of 1992-1994, that the exchange rate was not referenced to prices, but that it was directly determined in the money market. In other words, the exchange rate was directly determined by the rational expectations over future growth of money supply, implying that real money holdings were denominated in foreign currency. A conclusion emerged that 'dollarisation' played an important role in the Yugoslav hyperinflation. The result was also supported by Nielsen (2004).

Arsić, Mladenović and Petrović (2001) provided an overview of the main macroeconomic imbalances in the period following hyperinflation (*1994-2000*). They notice that during those years, the real money demand almost halved comparing to the 1980s' figure (6 and 15 per cent, respectively), hence illustrating a low credibility of economic policy in the second half of 1990s. The authors also find that, during the observed period, money supply was exogenous, driving wages, exchange rate and price levels. In this, the result that the exchange rate is determined by money supply is seen as a legacy of the Yugoslav hyperinflation 1992-1994, confirming that even after hyperinflation the macroeconomic instability was fuelled by monetisation of fiscal and quasi-fiscal deficits. Money supply, however, happens to influence prices only through wages and exchange rate. Herein, prices are found to be sticky with respect to exchange rate, which appears to be the result of a relatively closed Yugoslav economy throughout the 1990s (Arsić *et al.*, 2001, p. 10). Moreover, the study reveals a long-term trade off between real wage rate and real exchange rate, meaning that real devaluation leads to fall in real wages.

In relation to initial stabilisation period (*2000-2001*), the same authors discover that the credible stabilisation offered a 'free lunch' through: (i) a strong increase in real money demand used to mounting up of foreign currency reserves, (ii) non-inflationary growth in money supply accommodating increase in real money demand, (iii) large real depreciation of dinar that restrained inflation by using nominal exchange rate as an anchor, and (iv) sustained budget deficit relaying on increased tax revenues coming from a broadened tax base. The first year of stabilisation was also characterised by a huge growth of real money holdings of 173 per cent (Arsić *et al.*, 2001, p. 15), which largely resulted from real dinar appreciation.

The authors also argue that real exchange rate, after a year of stabilisation, reached the average 1994-1998-level, thus draining out the scope for initial real appreciation. Similarly, the wage growth in DEM terms of 120 per cent was considered to be sustainable and in line with its historical levels. Arsić *et al.* (2001), thus, warn that further real exchange appreciation and wage growth should only take place if accompanied with structural reforms and increased productivity, thereby nominating this approach as an alternative policy mix for Serbia's (post-)stabilisation period.

Arsić, Mladenović, Nojković and Petrović (2005) conducted the econometric modelling of Serbian economy in the (pre-)stabilisation period (*1999-2004*) and discussed implications of their findings on monetary and economic policy. As pointed in Chapter III, the current account deficit resulting from ever growing trade deficit, has appeared to be the main macroeconomic imbalance of the Serbian economy since stabilisation inception to date.

Appreciation of real dinar exchange rate and excessive domestic demand growth are found to be the main deriving force behind the widening of foreign trade deficit. The influence of the exchange rate on imports is statistically so strong that encompasses very heterogeneous periods; 1999-2000 when the economy was 'closed' and 2001-2004 when the economy opened rapidly (Arsić *et al.*, 2005, p. 213). During 2001 and 2002 the dinar was used as nominal anchor and was largely undervalued, which offered a chance for a sustainable growth strategy. However, subsequent huge dinar appreciation wiped out such policy option and focused on complete exchange rate stability and rapid disinflation. The authors argue that this reflects the ailing prioritisation of economic objectives from long-term to short-term results. Even though a policy turn took place at the beginning of 2003 allowing for real exchange rate depreciation, the continuous increase in foreign trade deficit points to still existing dinar overvaluation.

According to Arsić *et al.* (2005), the expansion of domestic demand (especially consumption) influenced raising imports above the level determined by the real exchange rate and wages through overspending of privatisation receipts in period November 2003 to June 2004. The effect of reduction in tariff rates that took place in August 2003 in view of harmonisation with Montenegro (see Chapter III) was found to have had symbolic influence on import rise. Also, the authors claim that the entire tariff reduction could have been neutralised had the appropriate dinar exchange rate policy been put in place. Moreover, the growth of domestic demand is found to have had a much greater effect on increasing imports than on amplifying domestic output growth. Furthermore, Arsić *et al.* (2005) calculate that only between one-quarter and one-third of nominal exchange rate depreciation is transposed into inflation (NBS (2004c, p. 32) estimated the exchange rate pass-through to prices of 0.32), thus suggesting an alternative policy option including real dinar depreciation combined with reduced wages and domestic spending.

An interesting part of this study, however, relates to the assessment of the exchange rate and monetary regime – managed float – as officially announced policy approach during the observed period. *De facto*, however, the National Bank of Serbia implemented a fixed exchange rate in 2001 and 2002, while it turned to a policy of moderate dinar depreciation in 2003-2004 by dominating the foreign exchange market through its daily interventions. In relation to this, the authors suggest that the NBS withdraw from daily interventions, leaving the market to determine the exchange rate:

> "The NBS tends to release simultaneously forecasts on the exchange rate level and the target inflation rate, which is methodologically and conceptually inconsistent. By announcing the exchange rate forecasts, the NBS creates an impression in the public that it is targeting the exchange rate, whereby undertaking a form of obligation towards the public. This NBS commitment becomes important in the case when, like in Serbia, a large portion of loans is extended under an FX [foreign exchange, auth. remark] clause. The public may perceive that exchange rate is fixed or that will depreciate just a bit, thus miscalculating the credit costs. [...] Instead of simultaneous targeting of inflation and the exchange rate, the NBS should clearly define and announce the monetary regime. This might be, having in mind the relevant comparative experiences, inflation targeting." (Arsić *et al.*, 2005, presentation, p. 3).

Maravić and Palić (2005, p. 21) find, for the period *January 1996-March 2005*, that money demand in Serbia is instable[39] and thus "could not be used for the purpose of targeting monetary aggregates". In particular, Maravić and Palić (2005, p. 15) claim that money demand in Serbia is mainly affected by inflation expectations (1 per cent of inflation induces 1.08 per cent growth in money demand), and nominal dinar depreciation (1 per cent in dinar depreciation leads to 0.19 per cent reduction in money demand with a one-month time lag), whereas interest rates are found to have only limited effects on money demand (1 per cent rise in interest rates leads to 0.06 per cent fall in money demand with a four-month time lag).

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[39] Among the reasons for the money demand instability one can find the underlying structural characteristics of Serbian economy and nature of shocks to which the country is exposed. We recall from Chapter III that, for the last 15 years or so, the country was exposed to various types of external and structural disturbances such as: dissolution of the SFR Yugoslavia (1991), military conflicts among the former-Yugoslav republics (1991-1995), UN sanctions (May 1992-November 1995), privatisation of the national telecommunication company (August 1997), the Kosovo crisis and NATO raids (1999), 'bulldozer revolution' (October 2000), general price liberalisation (December 2000), trade liberalisation (December 2000 and August 2003), liquidation of four large state-owned banks (January 2002), replacement of the deutsche mark by euro (first half of 2002), transfer of payment operations from ZOP to commercial banks (January 2003), VAT introduction (January 2005). The list is, however, not exhaustive as it should also include changes in ownership structure resulting from privatisation and other accompanying reforms typical for a transition economy.

Finally, the IMF (2005) analysis of inflation determinants in Serbia reveals that the exchange rate is a primary factor of inflation in the short run, along side income and output gap, while broad money growth (M2) is found to be statistically insignificant. In this, the pass-through effect from exchange rate to inflation from 0.4 in the medium term to 0.7 in recent years may be seen as a result of a managed exchange rate policy. IMF (2005, p. 47) also argues that the growing share of imports in GDP sets "0.4-0.5 as the 'natural' lowest threshold for reasonable pass-through estimates for 2004-05". Low impact of money growth on inflation is likely to derive from high euroisation of Serbian economy estimated to have increased from 45.7 per cent in 2001 to 54.7 per cent in 2004 (Maravić and Palić, 2005, p. 16). Moreover, the euroisation itself is found to have contributed to the strong pass-through effect on inflation.

The deliberation about the factors influencing the choice of monetary policy strategy, subsequent elaboration of monetary flows in Serbia in period since late 1980s, and previous analysis of (macro)economic fundamentals of the Serbian economy (Chapter III) reveal the following:

- Money supply in Serbia happens to influence prices through wages and exchange rate (i.e. prices are highly indexed to exchange rate movements);
- High level of euroisation results in low impact of money growth on inflation;
- Money demand in Serbia is instable and mainly affected by inflation expectations and nominal dinar depreciation;
- There is a long-term trade-off between real wage rate and real exchange rate, as real devaluation leads to fall in real wages.

Due to the obvious historical reasons and dreadful experience with two devastating hyperinflations, there exist a strong anti-inflationary bias that drives monetary fundamentals in Serbia through inflation expectations and a high *de facto* euroisation. This further reduces the level playing field for the National Bank of Serbia, which credibility has been seriously undermined on several occasions in the last 15 years (see Chapter V). We feel that this credibility can only be restored by the resolute adherence to a credible anchor. In this respect, Serbia's experience so far is telling.

4.4.2. Serbia's experience with monetary and exchange rate regimes

Under the socialist economic setting the exchange rate was mainly fixed. Dinar was only convertible on the streets and abroad. During the 1970s, inflation was slightly higher then in Germany and, thus, the real exchange rate was appreciating. The pursued monetary policy was based on negative real interest rates, as the foreign currency deposits held at domestic banks earned higher nominal interest rates then the dinar deposits (see Gligorov, year unknown). In the 1980s, the exchange rate was not fixed any more, but the authorities continued applying the same monetary policy. Consequently, the dinar was constantly devalued and high inflation prevailed.

During 1989, both the interest rate and inflation served as nominal anchors, creating heavy disturbances in the monetary and exchange rate policy. According to Savić (1989), this points to the fact that there were no adequate nominal anchors in that period; inflation was rising. In such circumstances, several options were considered, including the adoption of the currency board, but were equally rejected.[40] At this time, the official markisation was not considered at all. In late 1989, the exchange-rate-based programme was installed (the Marković's programme), assuming the dinar convertibility in current transactions. Large dinar devaluation preceded. As of 18 December 1989, the dinar was pegged to DEM. Nominal exchange rate was fixed. Even after the programme implementation, however, around 50 per cent of deposits were still held in foreign currencies, pointing to high markisation and low programme credibility. During December 1990, the dinar devalued nominally by 30 per cent indicating the start of new inflation wave (Petrović *et al.*, 1999, p. 342). Throughout the 1990s the real exchange rate appreciated, further deteriorating an external competitiveness of Yugoslav exports.

Fixed exchange rate was abandoned in early 1991. The dinar lost its functions as a store of value and a unit of account and was under threat to completely lose its function of a medium of exchange. The existence of a very high *de facto* markisation, which put in motion an informal exchange-rate-based pricing, was supported by ample anecdotal evidence (e.g. formation of green market prices).

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[40] "The alternative option on offer was not altogether articulated, but did include a flexible exchange rate and some kind of a more federal system of central banking (this is the unclear part). This was not supported by the IMF and was not politically feasible anyway" (Gligorov, year unknown, p. 3).

By February 1992, Yugoslavia entered the state of hyperinflation in which large currency depreciation played a great role. The entire period of hyperinflation, which lasted until February 1994, witnessed the National Bank of Yugoslavia's loss over money creation. The stabilisation programme that was put in place (Avramović's programme) on 24 January 1994 formally opted for a crawling peg system under which the exchange rate was supposed to be formed freely. The monetary policy relied on nominal exchange rate anchor. Up to June 1994, however, the programme represented a quasi-CBA, as the entire primary money issue was fully backed by the central banks' foreign currency reserves.

The period following the collapse of Avramović's programme (mid-1994 to 1999) is generally insufficiently covered by both Serbian and foreign literature. What is known, nevertheless, is that during that period the dinar was officially pegged to DEM and was used as nominal anchor (Barisitz, 2004, p. 97). In reality, however, the multiple exchange rates were in effect. The average growth rate of nominal variables (base money, M1, inflation, exchange rate) of around 40-50 per cent, as found by Petrović (2004, p. 2), indicates the existence of very low confidence of the general public in the economic policy of the second half of the 1990s.

Following the Kosovo crisis and NATO foray (24 March–9 June 1999), the National Bank of Yugoslavia lost competency over the monetary and exchange rate regimes in Kosovo and Metohija. The province was semi-euroised from September 1999 onwards, when the UN administration (EU-led Pillar IV)[41] permitted the free use of foreign currency, alongside with the dinar. Inner Serbia continued using the dinar that, after the outbreak of the Kosovo conflict, strongly depreciated in real terms and was accompanied by fast demonetisation (i.e. a flight from the domestic currency into the foreign currency). Foreign exchange reserves of the central bank dried out, amounting for a mere USD 297.4 million in December 1999 (Arsić *et al.*, 2001, p. 13). Following the democratic changes, which commenced in October 2000, the regime of a tight managed float was introduced in December 2000 with the nominal exchange rate anchor. The exchange rate of the dinar was practically fixed.

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[41] "The United Nations Interim Administration in Kosovo (INMIK), created in June 1999 by Security Council Resolution 1244, consists of four pillars, namely Pillar I: Police and Justice, under the direct leadership of the UN; Pillar II: Civil Administration, under the direct leadership of the UN; Pillar III: Democratization and Institution Building, led by OSCE; Pillar IV: Reconstruction and Economic Development, led by the EU" (Barisitz, 2004, p. 105).

The period of initial stabilisation (2001-2002) was characterised by the fixed nominal exchange rate and the real exchange rate appreciation of 95 per cent (Arsić *et al.*, 2005, p. 209). During those two years, euroisation remained very high primarily due to raising real wages and increasing remittances (see Chapter III). Also, the conversion of the deutsche mark banknotes ('mattress money') into the euro-denominated deposits in the course of 2002, that was taking place mainly through the banks, contributed to strong euroisation estimated to amount to around EUR 2 to 3 billion (IMF, 2005, p. 72). As a result, in the third quarter of 2002, the share of foreign-currency-denominated deposits in total deposits equalled to 54 per cent (IMF, 2005, p. 67). This was understood as a lack of credibility of stabilisation policies. However, as already explained, euroisation tends to remain high even after successful stabilisations as a result of hysteresis and 'network externalities'[42]. Nonetheless, euroisation in Serbia supported remonetisation, financial intermediation and portfolio diversification.

Since January 2003, the National Bank of Serbia has somewhat loosened the dinar's float, which nominally depreciated by about 11 per cent against the euro and appreciated by around 7 per cent against the dollar (Barisitz, 2004, p. 111). The real effective exchange rate of the dinar, however, remained largely unchanged during 2003. In 2004, real exchange rate depreciated only moderately, as nominal exchange rate continued depreciating faster then the difference between the domestic and the euro inflation (Arsić *et al.*, 2005, p. 209). Starting from 2003, the NBS officially used the real exchange rate as an anchor. While remonetisation stagnated, euroisation continued to increase and already by end-2004 about 65-67 per cent of all deposits were held in the foreign currency. Several factors contributed to high euroisation such as prevalence of negative real interest rates on dinar deposits and foreign banks facilitation of euro-denominated deposits and euro-indexed lending. At the mid-August 2005, the total forex reserves amounted to USD 5.8 billion, thereby reaching its 1989-level, after full 16 years. The fact that those reserves cover by 200 per cent the monetary aggregate M1 proves that the quasi-CBA is currently *de facto* in place in Serbia.[43]

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[42] According to the IMF (2005, p. 72), "[t]he utility of using a specific currency as a store of value, medium of transaction, medium of account etc. increases with the number of economic agents choosing the same currency for these purposes [...]".

[43] This fact was revealed by the NBS Governor Jelašić in May 2005 during the EBRD Annual Conference.

Table 4.3. provides an overview of Serbia's experience with monetary and exchange rate regimes (1989-2004). What is striking is that throughout the period, with the exception of (pre-)hyperinflation years and the year 1999 (Kosovo conflict), Serbia was actually operating the quasi currency board regime with the exchange rate as nominal anchor. Also, the conducted analysis points to the fact that Serbia is highly euroised economy comparing to the international standards (see IMF, 2005).

Table 4.3. *Serbia's experience with monetary and exchange rate regimes (1989-2004)*

Regime	1989-1990	1991[1]	1992-1993	1994-1998	1999-2000*	2001-2002*	2003-2004*
Exchange rate regime	Fixed exchange rate (Since 18 December 1989)	Fixed exchange rate	Fixed exchange rate	Crawling peg (DEM) (Since 24 January 1994)	Peg to DEM (EUR)	Tightly managed float (Since 1 January 2001)	Managed float
	De facto: Quasi-CBA	-	*De facto*: State of hyper-inflation	*De facto*: Quasi-CBA (until June 1994); Multiple exchange rates	*De facto:* Fixed exchange rate (since October 2000)	*De facto*: Fixed exchange regime; Quasi-CBA	*De facto*: Quasi-CBA
Monetary regime	Nominal exchange rate anchor (DEM)	-	Nominal exchange rate anchor (DEM)	Nominal exchange rate anchor (DEM)	Nominal exchange rate anchor (DEM)	Nominal exchange rate anchor (EUR)	Real exchange rate anchor (EUR)

Notes: * Not related to Kosovo and Metohija.
[1] The year of dissolution of SFR Yugoslavia.

Source: Author.

As a result, two conclusions emerge. The first and more general conclusion is that the public in Serbia is extremely inflation averse due to the demoralising experience with the hyperinflations and monetary mismanagement of late 1980s and 1990s. To put it differently, the economic agents in Serbia highly value both currency and inflation stability notwithstanding the fact that they have learned, over time, how to effectively hedge against the currency and inflation risks. Implications of this reality to monetary and exchange rate policy choices are quite stringent. Whoever is to take a seat at the governing boards of the National Bank of Serbia is *a priori* sentenced to conservatism, as monetary experiments are not welcomed (see also Section 5.3.2). Although this is not negative in itself, it constrains adequate prioritisation of different macroeconomic objectives at given times.

Secondly, and more technically, the existence of a quasi-CBA requires continuous maintenance of foreign exchange reserves at a very high level, which could otherwise be used for more lucrative purposes. Besides, under the quasi-CBA and high euroisation, the scope for monetary and exchange rate interventions drastically narrows. Notably, for years, the NBS has basically been: (i) unable to control the expansion of broad money and credit, (ii) it has been experiencing the 'fear of floating' due to the potential balance sheet risks, (iii) it was decoupled from a part of seigniorage revenues (estimated at 0.6-2 per cent of GDP)[44], and (iv) the exercising of its lender-of-last-resort function has been subdued by the potential loss of credibility of its exchange rate policy.

Operating under such a setting, the National Bank of Serbia was during 2001 and 2002 applying an overly restrictive monetary and exchange rate policy, obstinately refusing to devalue dinar despite the growing trade deficit.[45] This opened a vividly debate, which swung around a single question: 'To devalue or not to devalue the dinar?'. Gligorov (year unknown, p. 9), however, rightly notes that the real issue was more whether the devaluation could have been effective in the context of high currency substitution. According to this author, the history argues against it (as population euroise to hedge against the devaluation at the first place), but since wages were not contracted nor indexed to the euro, devaluation might have brought some positive effects.

This initial debate was in a way closed in early 2003, when the NBS started gradually moving towards less rigid exchange rate regime, depreciating the dinar moderately (1.1 per cent in 2004). The next issue that was put on the agenda – apart from an intense debate surrounding the drafting, adoption and implementation of the new National Bank of Serbia Law (see Chapter V) – was whether the exchange rate could and should be used for attaining the sustainable balance of payments situation and whether the applied exchange rate and monetary regimes qualify for such task.

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[44] IMF (2005, p. 74) estimated that the minimum of foregone seigniorage would amount to 0.6 per cent of GDP under the assumption that about EUR 3 billion in cash circulate in Serbia, replacing an equivalent amount of dinar-denominated cash. Arsić *et al.* (2001, p. 6) calculated that, despite high money growth (1994-2000), the collected seigniorage could finance only relatively small fiscal deficit of about 2 per cent of GDP.

[45] Throughout that period, the Serbian exporters have been persistently requesting devaluation of the dinar, pointing to the huge loss of competence of domestic exports *vis-à-vis* other countries' tradables. See, for example the Serbian weekly magazine *Ekonomist* [The Economist] No. 82 dated 17 December 2001, the interview with Mr. Slobodan Korać, the President of the Yugoslav Chamber of Commerce, and No. 100 dated 22 April 2002, the interview with the National Bank of Yugoslavia Governor Mlađan Dinkić.

The answer, in principle, depends on two factors. The first presupposes the existence of a common understanding between the politicians and experts about the underlining real fundamentals and monetary transmission mechanism, which drive the economy (see Kornai, 1990). Such consensus in Serbia in 2005 was clearly not present.[46] The second factor is prioritisation of policy objectives, which is ultimately determined by the ruling government's political preferences. We conclude, based on the fact that the NBS was up to 2004 very reluctant to depreciate the dinar substantially, that the priority was on the side of containing the possibility of banking crisis (see also IMF, 2005). As from mid-2004, the authorities assigned more weight to the external objective (see Barisitz, 2004), silently switching its policy preference.

The problems of the Serbian economy are, however, quite acute thus requiring a broad consensus of all interested parties (politicians, experts, general public, industry) about a comprehensive economic (including monetary and exchange rate) policy approach. The prevailing disagreements point to the fact that this may as well be a critical moment for Serbia to revise its monetary policy strategy. The policy of 'being neglect' in which the NBS mutely continues its current policy does not seem to be the optimal solution. Alternatively, Serbia may opt for: (1) official euroisation, (2) formal CBA introduction, (3) flexible exchange rate target, or (4) freely floating exchange rate.

Besides the fact that the first two options have in Serbia traditionally been rejected whenever considered[47], they would also require substantial efforts in approximation of legislation and institutional changes. Moreover, the functioning of any of those two regimes would require practical adaptation of everyday operations of the National Bank of Serbia, which are both costly and time-consuming. Therefore, the first intuitive answer would be that those two options would most probably not materialise, at least not in a foreseeable future. Nevertheless, in order for a credible decision to be made, additional analysis focusing on the potential costs and risks, which may occur in the case of unilateral euroisation or a currency board arrangement, should be conducted.

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[46] See, for example, the magazine *Ekonomist*, No. 249 dated 28 February 2005, which brings the interview with the Serbian leading macroeconomist Professor Pavle Petrović about the findings of the CESMECON study on macroeconometric modelling of the Serbian economy, and a replay published in the *Ekonomist*, No. 253 dated 28 March 2005 in an interview with Mr Miroljub Labus, the Serbian Deputy Prime Minister.

[47] See, for example, Iglić (1999), Lučić (1999), Savin (1999) and Ognjanović (1999) for the discussion about the possible introduction of a currency board arrangement in Serbia.

Moreover, as explained previously, the CBA as a form of fixed nominal exchange rate target, is only advisable for very open economies with the ratio of openness higher then 72.5. Serbia (and Montenegro), however, has a relatively low degree of openness of 60.7 (Zaman, 2004, p. 20).[48] Also, the fixed nominal exchange rate target appears to be a superior solution only for those countries with the inflation differential *vis-à-vis* the anchor currency (the euro) of less then 3 per cent, which have completed their disinflation and price liberalisation processes (see Bofinger and Wollmershaeuser, 2000). In Serbia, this is clearly not the case. Moreover, since both options (CBA and unilateral euroisation) lack the lender-of-last resort function, their adoption in Serbia could substantially increase the financial sector fragility.

With regards to the option of a freely floating exchange rate regime (option 4), the situation is pretty straightforward. Such regime is treated as a corner solution, just as the rigidly fixed regimes (CBA and euroisation), although placed at an opposite end. The floating exchange rates are perceived to have a detrimental impact on cross-border investment and to be incompatible with the ERM II (ECB, 2003, p. 3). The fact that the literature on transition from a centrally planned economy towards a market-based economy makes no reference to a freely floating exchange rate regime is another confirmation of inappropriateness of such regime for Serbia in given circumstances.

The choice is, consequently, narrowed down to the so-called 'intermediate solution' (options 3 in our case). We believe that the flexible exchange rate target should be a preferred policy option for the NBS in the forthcoming period in which a sequential capital account liberalisation should also take place. In this, an active crawling band appears to be an appealing option for Serbia. This is especially so as "a crawling band is capable of achieving a reasonable trade-off between the conflicting objectives of reducing inflation and maintaining export growth" (Williamson, 1996, p. 101)[49]. Besides, the various implementing options under such regime would allow the NBS to further sharpen its focus (e.g. to publicly announce inflation target *or* exchange rate target) and set a relatively wide band of fluctuations, as a safety margin against large capital inflows.

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[48] According to Zaman (2004, p. 20), Croatia has a degree of openness of 113.3, while Romania and Bulgaria exhibit the same degree of openness of 80. Bofinger and Wollmershaeuser (2000, p. 22) state that the ratios of openness for the Czech Republic, Hungary, Poland and Slovenia are 60.3, 39.6, 27.8 and 57.7, respectively.

[49] Cited by Bofinger and Wollmershaeuser (2000, p. 22).

That exchange rate targeting is still a superior option for Serbia in comparison to other targeting approaches is documented by the fact that macroeconomic fundamentals have not yet settled (see Chapter III). The adoption of direct inflation targeting, as suggest by some authors[50], would thus be premature given the non-existence of a stable quantitative relationship linking monetary policy instruments to future inflation. Besides, there is lack of political consensus over the low inflation and central bank independence (see Chapter V), both of which are considered to be prerequisites of direct inflation targeting. However, inflation targeting in combination with the greater exchange rate flexibility, as proposed by Masson (1999), in our view may be an adequate *transitory solution* to be implemented in Serbia in the period preceding the EU membership.

4.4.3. The Maastricht criteria in the shadow of the Copenhagen criteria

As already explained, the countries that joined the EU on 1 May 2004 are the Member States with a derogation, meaning that they had not adopted the euro at the outset of their membership. It is likely that Serbia will share their same faith, once it joins the EU (see Dvorsky, 2004). In any case, Article 124 of the Treaty requires all Member States treat their exchange-rate policies as a 'matter of common interest'. Herein, "the choice of the monetary and exchange rate strategy after EU accession is, in the first instance, a responsibility and prerogative of the Member State concerned" (ECB, 2003, p. 1).

The Treaty, nevertheless, does prescribe a set of macroeconomic criteria (the Maastricht criteria) that must be fulfilled before the euro is adopted without stipulating how these criteria are to be met. It is certain that there is no one single path towards the adoption of the euro. Presumably, though, each Member State with a derogation will be committed and will strive towards a swift adoption of the single currency, in which case the Maastricht criteria become very important. Having in mind, however, that these involve the alignment of inflation, government debt, budget deficit, nominal long-term interest rate and exchange rate, we believe that cautious policy considerations must take place well before the actual EU membership.

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[50] See, for example, Arsić *et al.* (2005) and IMF (2005).

In the case of Serbia, this means that a broad, long-term macroeconomic framework should be designed by the relevant authorities, the National Bank of Serbia and the Ministry of Finance in the first place. Currently, there are no clear indications that such exercise is taking place or that it has been envisaged. The closest the Serbian authorities get to such document is by preparing the Poverty Reduction Strategy Paper[51], a three-year memorandum on the budget and economic and fiscal policy for a given year with the projections for the subsequent two years[52], and by the National Strategy for European Integration.[53] The Strategy, in particular, recognises that the Maastricht criteria should start being looked at as guidelines for the maintenance of a sustainable macroeconomic stability (see Government of the Republic of Serbia, 2005).

Vis-à-vis the *monetary policy*, the Strategy notes that monetary policy should follow the policy of neutral money by: (i) maintaining the monetary equilibrium as a precondition for the stability of prices and equilibrium exchange rate, (ii) greater reliance on open market operations, (iii) building of the elements of sterilisation of the primary money created on the basis of capital inflows from abroad, (iv) strengthening the supervisory role of the NBS and protection of financial system from the influence of state bodies or interest groups, and (v) establishing the limits for commercial banks' acquisition of public debt instruments.

In relation to the *fiscal policy*, the Strategy stresses that fiscal sustainability represents the major challenge, recommending that the structure of the public expenditures be changed in favour of investments and education. Also, the document proposes that either: (1) the tax burden be reduced in view of increased fiscal revenues, or (2) a budget surplus be formed that would reduce the pressure of domestic demand on imports and consequently on the exchange rate.

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[51] Government of the Republic of Serbia (2003c).

[52] The document is produced by the Ministry of Finance of the Republic of Serbia once a year in line with the relevant provisions of the Budgetary System Law (Official Gazette of the RS, No. 9/02).

[53] It should be noted that under the IMF arrangements, Serbia has been obliged to implement a set of agreed macroeconomic and structural conditions, which may be regarded as a comprehensive medium-term policy framework. However, this approach does not have a 'European component' as was demonstrated on several occasions. One example is a linear 10 per cent cut-off in the number of public servants, which took place in 2005 as a result of an agreement with the IMF. This measure, aimed at reducing the overall public expenditure turned out to be contrary to the general recommendation of the European Commission for Serbia to further build its administrative capacity, necessary for the process of accession of the country to the EU. It would be a logical step to establish some form of co-ordination between the actors (Serbian government, the EU and the IMF), as to ensure the sustainability of the undertaken reform tasks.

Under the heading of *foreign trade policy*, the Strategy puts forward several points, which are of interest to our work. Firstly, it rightly notes that the Serbian foreign policy in the years to come will be defined within the context of multilateral and bilateral negotiations for membership in the World Trade Organisation and the Stabilisation and Association Agreement, respectively. Secondly, the document argues that the foreign exchange transactions, regulated by the Law on the Foreign Exchange Transactions[54] and the Law on the Foreign Credit Relations[55], are problematic due to the existence of inconvertibility of current transactions and restrictions imposed on capital transactions. Moreover, the existence of monopolies is recognised as a threat to further capital liberalisation. Thirdly, the Strategy proposes that the evolvement of the issue of Serbian current account deficit should be looked against the background of its volume (determined by the domestic demand financed *via* new loans that, in turn, affect the sustainability of foreign debt) and its structure (imports of equipment necessary for production *versus* imports of consumers goods driven by increased domestic consumption). Finally, the document concludes that the answer to the unsustainable Serbian current account deficit should be sought in the management of the deficit's structure and volume and not in the regulation of the degree of foreign trade liberalisation (by imposition of trade restrictions) or by the exchange rate policy, which are both seen only as corrective factors.

Regarding the *exchange rate policy*, the Strategy asserts that the exchange rate regime should *not* be regarded as the most important instrument of economic policy, but instead should be considered in connection with fiscal, monetary and financial developments. Moreover, the document argues that "it is not necessary to make a choice between the fully fixed or fully floating exchange rate systems, but rather between the different degrees of flexibility" (Government of the Republic of Serbia, 2005, p. 58). Additionally, the entire projection of economic growth in Serbia up to 2010, brought by the Strategy, is built on the assumption of the existence of a stable exchange rate based on moderate real depreciation of the dinar *vis-à-vis* the euro up until 2007, after which period the exchange rate policy is supposed to be 'neutral'.

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[54] Official Gazette of the FRY, No. 23/02 and 34/02 (applicable to Serbia only).
[55] Official Gazette of the FRY, No. 42/92.

In this model, *inflation* is projected at 10.1, 7.2 and 5.9 per cent for the years 2005, 2006 and 2007, respectively, whereas for the period 2008-2010 it is projected to be at a constant 5 per cent. In addition, it is recognised that a precondition for the maintenance of inflation rate at such low level (in comparison to historical figures) would be to impose rigorous financial discipline and to bring down the entire public spending within 'realistic' limits. Besides, the Strategy finds that the competition must be strengthened and that monopolies must be prohibited for the purpose of eliminating the sources of destabilisation of domestic supply and demand and therewith of the overall price level.

The overview of the proposed policy measure given by the Serbian Strategy for European Integration reveals one striking feature; that the Serbian authorities are overwhelmed by the transition tasks. An instantaneous consequence of such finding is that the formal Maastricht criteria can only be contemplated against the background of a prolonged macroeconomic instability and delayed structural reforms. In other words, it seems a way too premature to discuss the Maastricht criteria when the Copenhagen criteria requiring the existence of a functioning market economy is not even near to realisation.[56] Our conclusion is a result of analysis performed in other parts of this thesis, which have then been confronted with the established methodology of the European Commission released in 1997 for the purpose of preparing the so-called Regular Reports:

- "equilibrium between demand and supply is established by the free interplay of market forces; prices, as well as trade, are liberalised;
- significant barriers to market entry (establishment of new firms) and exit (bankruptcies) are absent;
- the legal system, including the regulation of property rights, is in place; laws and contracts can be enforced;
- macroeconomic stability has been achieved including adequate price stability and sustainable public finances and external accounts;
- broad consensus exists about the essentials of economic policy." (EC, 2004, p. 6).

[56] The economic Copenhagen criteria also include the capacity to withstand competitive pressure and market forces *within* the Union, but this criterion can only be assessed once a country joins the EU.

In particular, we assert that in the Republic of Serbia due to the existence of public monopolies[57], which substantially hamper the competition, the prices and (internal) trade have not been sufficiently liberalised. As a result, the prices of a number of services, including the financial services (e.g. interest rates in the case of banking sector) are still unnecessary high. In other words, the prices in those sectors are not entirely determined on the basis of supply and demand, but are formed in line with the planned or envisaged privatisation strategies. By refusing to break the monopolies and by keeping the capital account almost firmly closed[58], the authorities presumably hope to obtain better prices for banks, insurance companies and companies that are in the process of privatisation. This, further, points to the short-term policy orientation, which evidently comes with the costs of slow structural adjustments and inability to secure a sustainable macroeconomic position (including monetary and exchange rate policies).[59] Consequently, the overall transition process has practically been trapped by these developments.

The prolonged macroeconomic instability has also been fuelled through another channel. Namely, the fact is that the capital account is almost completely closed and that the exchange rate is *de facto* fixed. At the same time, imports grew at a rate of 31.7 per cent in period 2001-2004[60], whereas the foreign exchange reserves have constantly been increasing partly due to steady FDI inflows, but also as a result of high donations and substantial borrowing. From a macroeconomic point, this situation is unattainable; it points to the possibility of debt crisis, urgently calling for a set of comprehensive, precautionary and consistent measures. In this, the monetary and exchange rate policy may only have a supporting role, although an important one.

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[57] Monopolistic positions of companies providing public services is ensured by an obsolete Law on Public Companies (Official Journal of the FRY, No. 6/91) and a number of other laws, such as the case with the Law on Telecommunications (Official Gazette of the RS, No. 44/03) securing the monopolistic position of *Telekom Srbija a.d.* in the area of fixed telecommunications until 9 June 2005 (Article 109). Herein, it should be noted, that the term 'public companies' does not correspond to the Anglo-Saxon meaning, as these companies in Serbia are not publicly traded but are, in fact, companies that provide service to the public (telecommunications, broadcasting, air transport, railways, etc.).

[58] Even the new Law on Foreign Exchange Transactions, adopted by the Government of the Republic of Serbia on 15 July 2005, which has a positivistic approach to the regulation of the area of foreign exchange transaction (as opposite to the current Foreign Exchange Law, which is overly rigid), introduced only minor changes relating to the liberalisation of capital account.

[59] This point has been publicly raised by the NBS Governor Jelašić on several occasions. See, for example, magazine *Ekonomist*, No. 271 dated 1 August 2005, p. 10.

[60] Prica (2005, p. 7).

4.4.4. Proposal for a new policy approach

All points to the fact that this is a critical moment for Serbia to sharpen its grit in relation to the remaining transition tasks. These, however, have to be looked at within the context of existing political commitments, which relate to the agreements the country has signed with IMF (focus on macroeconomic policies – fiscal, monetary, and exchange rate – aimed at facilitating sustainable growth)[61] and World Bank (support to structural reforms).[62] Besides, Serbia's declared policy goal to join the WTO and to conclude an SAA with the EU within 3-4 and 1-2 years, respectively, should also be considered. Taken together, these existing commitments set the basic policy framework out of which a concrete action plan can be drawn. Based on our analysis hitherto, however, we note that such framework is missing a strong EU-bias.

Acknowledging Serbia's strategic orientation towards the EU, we propose that the focus on the European integration be narrowed. The Serbian National Strategy for European Integration makes a vital step in that direction, but we suggest that the new approach also incorporates a complementary methodology, which should serve as a constant point of reference. This methodology can as well be the same as the one implemented by the European Commission in assessing the existence of a functioning market economy of candidate (accession) countries. In other words, we recommend that Serbian authorities use the E(M)U membership as a long-term policy anchor.

In short- and medium-term, Serbia can rely on the principles underlining the WTO membership and Stabilisation and Association Agreement, which include further trade, financial and capital liberalisation.[63] In order to be able to offer concessions in these areas, Serbia will undoubtedly have to decompose all existing monopolies and to complete the regulatory reform, especially in the domain of (financial) services. The approach would, thus, require a high-level policy co-ordination between the monetary, fiscal, foreign trade and other authorities.

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[61] See IMF (2005), Country Report, No, 05/13.

[62] "[...] the Bank leads the policy dialogue in (i) public expenditure management; (ii) macroeconomically important sectoral reforms (e.g. in the energy sector); (iii) pension, health and social assistance reform; (iv) the restructuring and privatization of enterprises; and (v) legal reforms with a bearing on the business environment, including labor markets" (IMF, 2005, p. 43).

[63] The example of other neighbouring countries (e.g. Croatia and FYR of Macedonia), which already signed the SAA and secured the WTO membership, may be instructive for Serbia.

Serbia has already liberalised its foreign trade substantially, which initiated a vivid debate about its consequences and dynamics; this debate being a lot more intense then the one, which has capital liberalisation at its centre. We, however, believe that greater attention should be given to the liberalisation and sequencing of the capital account, which will inevitably happen in the relatively near future (over the medium-term). In this, the lessons that have already been learnt in relation to trade liberalisation must be taken into account; most importantly, that the time is needed for the economy in transition to restructure and to resume growth (see Chapter III).

The increased competitiveness of domestic industry should be a starting point, as by improved competitiveness the current discomfort (deriving from a mounting current account deficit) and the likelihood of debt crisis will be contained and, possibly, even reduced. The major challenge in this would be to adequately coordinate the domestic and external sectors and to decide about the pace of liberalisation (radical *versus* gradual). The arguments in favour of the sequencing of capital account liberalisation, however, seem more compelling. First, prolonged macroeconomic stabilisation, which should precede the capital account liberalisation, has not yet materialised in Serbia. Second, Serbia has not yet completed the regulatory and financial sector reforms. Third, once institutionally encircled, the financial sector in Serbia should be further strengthened and prudential supervision controlling for manipulative and deceptive practices should be imposed before free movement of capital can be allowed[64]. It therefore appears that time is needed for Serbia to restructure fundamentally, calling for sequenced liberalisation.

The decision about the alternative sequencing strategies should be evaluated *vis-à-vis* their contribution to the broader objectives of financial sector reforms and durable macroeconomic stability (see Johnston, 1999). For that purpose, the benefits (increased competition, financial intermediation and risk diversification) and risks (effects on the exchange rate and interest rate developments) associated with the capital account liberalisation must be assessed.

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[64] According to Johnston (1999), prudential supervision should oversee both the domestic and foreign activities of financial institutions in view of transfer risk, sovereign risk and country risk. Besides, prudential regulation should be design in a way to control the management of foreign exchange risk exposure and foreign exchange liquidity. Moreover, prudential regulation should address issues of weak banks, tax evasion, money laundering, and statistical reporting by market participants.

Implications of capital account liberalisation on monetary and exchange rate policies may be quite stringent, imposing the 'incompatible triangle', as explained earlier. Namely, under unrestricted capital mobility, either exchange rate stability or monetary policy autonomy (in setting the domestic interest rates) can be achieved at one time. We have seen that the authorities in Serbia have kept the exchange rate *de facto* fixed together with the controls on capital account for full four years (2001-2005) in order to stabilise the economy. However, if such exchange rate policy is maintained in future in line with the anticipated capital account liberalisation, there is a risk that the demand for domestic monetary aggregates will become more sensitive to international interest rate differentials (Johnston, 1999, p. 118), reducing the effectiveness of a fixed exchange rate regime in achieving domestic monetary objectives.

This further points to the fact that Serbia should consider adopting a more flexible exchange rate regime over the medium-term period, because flexible exchange rate regimes are found to better insulate the economy in the face of disturbances in domestic demand. Also, by adopting a more flexible exchange rate, Serbia will not be forced to subordinate its external objective and endanger the competitiveness of domestic industry, which should be its top policy priority. The analysis in Chapter II revealed that the foreign debt and current account sustainability are the most challenging tasks for the Serbian authorities in the forthcoming period. These objectives should thus be clearly stated and publicly announced not only by the government, but also by NBS.

Within the scope of this new policy approach, the most sensitive decision relates to the determination of the appropriate degree of exchange rate flexibility. Bearing in mind the high level of euroisation in Serbia, the scope of manoeuvre is limited, but it nevertheless has to be exploited, as long as the wages are not contracted nor indexed to the euro. Although the greater exchange rate flexibility could itself reduce the level of euroisation in Serbia, we believe that in any case a conscious decision about deploying a set of measures aimed at containing euroisation is made as a part of this new policy approach.[65] Moreover, the effectiveness of existing monetary instruments in the context of increased capital account liberalisation will also have to be reviewed and evolution towards the indirect monetary policy instruments stepped up (see Table 4.4).

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[65] IMF (2005) also makes a case for containing euroisation and minimising associated risks.

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The new policy approach outlined here started from the fact that in turbulent times, such are those Serbia has been passing through in the last 15 years and those that lie ahead, the knowledge about the economic fundamentals is incomplete. As a result, the NBS' potential to specify its future policy actions highly depends on its assessment about the future economic developments and the likelihood of possible alternative outcomes. Apart from assessing the probability of distribution of various scenarios, the central bank is also invited to assess the risks/costs associated with each of them. In the words of Alan Greenspan, the Chairmen of the Board of Governors of the Federal Reserve System[66]:

> "Despite extensive efforts to capture and quantify what we perceive as the key macroeconomic relationships, our knowledge about many critical linkages is far from complete and, in all likelihood, will remain so. [...] In effect, we strive to construct a spectrum of forecasts from which, at least conceptually, specific policy actions is determined through the tradeoffs implied by a loss-function."

In the case of Serbia, the major risk accompanying further real appreciation and real wage growth above the productivity level derives from the fact that these may continue contributing to the widening of current account deficit, thereby endangering the country's capacity to service its external debt liabilities producing currency and banking crises. Similar scenario is probable under the hypothesis of uncontrolled capital inflows. However, taking into account anticipated capital account liberalisation in view of WTO and SAA commitments, we propose that the monetary authorities in Serbia make a cautious stance assuming real dinar depreciation and greater exchange rate flexibility.

Once a high degree of capital account liberalisation is achieved, however, the National Bank of Serbia may wish to switch to direct inflation targeting. It is a policy approach, which was followed by some other countries in a run-up to EMU (e.g. Poland). Inflation targeting may contribute to increased NBS credibility, by establishing a clear and transparent mode of operation. It seems, however, to be premature for Serbia to adopt this monetary regime at this moment when the structural reforms are incomplete and predictable relationship between monetary instruments and future inflation inexistent. Moreover, the complexity of such approach requires that the NBS first be strengthened in institutional and administrative terms before turning to a direct inflation targeting.

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[66] Extracted from a speech 'Reflections on Central Banking' delivered on 26 August 2005 at a symposium. in Wyoming, US. Mr Greenspan is also the Chairmen of the Federal Open Market Committee.

4.5. Conclusion

This chapter described the complexity of the monetary strategy selection process within the context of transitional environment and in view of perceived Serbia's E(M)U membership. In performing the assigned task, we have chosen quite deliberately to attach additional weight to the explanation of theoretical issues surrounding the process of selection of adequate monetary strategy (see Section 4.2). Such reasoning came as a reaction to the realisation about the inconsistent use of certain monetary economics' concepts by the Serbian economist, policymakers and the general public. The basic idea was to put the Serbian monetary developments on the 'standard' route, out of which it is often displaced due to the belief that Serbia is a 'special' case. Notwithstanding the country's specific characteristics and unique historic circumstances in which the monetary policy strategies were conceived, our analysis proves that universal rules apply in Serbia too and that thus they need to be acknowledged.

The analysis also reveals that the understanding about the E(M)U requirements is abstract and that the process of European integration is often overlooked and oversimplified. Thus, the entire Section 4.3. was devoted to the explanation of the E(M)U membership requirements relating to monetary integration, as given by the relevant provisions of the EU primary and secondary legislation. Against this background, we also looked at different exchange rate options, notably the currency board arrangements and euroisation. We conclude that, although Serbia at periods *de facto* operated the CBAs and was highly euroised (including the present situation), the likelihood of a formal CBA or official euroisation being adopted in Serbia in the foreseeable future is minute.

Our conclusion is also based on the finding that transition in Serbia is still in progress, driving the process of European integration, as explained in Section 4.4. Consequently, the contemplation about the macroeconomic Maastricht criteria is constrained by a more immediate need to contain domestic spending and real wage growth below the productivity levels. In this, the National Bank of Serbia is expected to take an active role by depreciating the real dinar exchange rate (see Arsić *et al.*, 2005). In a highly euroised economy, however, this places an additional burden on the central bank aiming to secure the financial system stability and external debt sustainability.

Nevertheless, the prevailing disagreements among politicians, economists and industry about the efficiency of the current monetary and exchange rate policies of the NBS in the period following the initial stabilisation of 2003 indicate that this may well be the critical moment for Serbia to rethink its monetary policy strategy. This task, we believe, can be approached in two ways: (1) some fine-tuning is employed so as to establish a steady and tenacious monetary policy framework, complementary with the structural measures that would make it possible in the first place, or (2) entire policy is reconsidered in view of alternative monetary policy targeting options and benefits they may bring to Serbia in terms of increased economic welfare.

This process, however, is not free from the outside influences as it depends on a number of considerations including the fact that: (i) Serbia is highly euroised economy, (ii) money demand is found to be instable, (iii) the transition from direct to indirect monetary instruments is not yet completed, (iv) degree of openness is still relatively low in comparison to some neighbouring countries, (v) there exist restrictions on capital movements, (vi) nominal wages exhibit downward rigidity although the internal labour mobility is relatively high, etc. Besides, the decision about the new monetary policy strategy would also need to reflect the anticipated future developments envisaged by the Serbia's WTO membership, conclusion of a SAA with the EU, and by the commitments incorporated in the agreements concluded with the IMF and the World Bank.

Our analysis, thus, points to the fact that the National Bank of Serbia will most probably continue targeting the exchange rate, as it had done traditionally. On a conceptual level, this indeed seems to be the preferred policy option at least in the period until a prolonged macroeconomic stabilisation is achieved. In this, however, the decision about the adequate degree of exchange rate flexibility must allow for the change of priorities away from a rapid disinflation to the resolution of the existing external imbalances and increased competitiveness. The purpose of this exercise would be to simmer down the debate about the effectiveness of the current NBS's policy, which has been greatly politicised, thereby blurring the process of selection of a monetary policy objectives, targets and instruments. More importantly, however, the deliberation about the Serbia's new monetary policy strategy should contribute to restoration of NBS's credibility that the Serbian politicians challenged on various occasions (see Chapter V).

Chapter V Serbia's New Central Bank Institutional Framework

5.1. Introduction

Up to this point, it has been demonstrated that the transition from a socialist to a market-based economic system is an all-encompassing process, which requires the involvement of various institutions, including the central bank. The analysis also disclosed that transition begins with macroeconomic stabilisation, in which the central bank plays an indispensable role. Thus, one cannot analyse the transition as such without assessing the role of the central bank, which in practice is at the centre of a complex process. The role of the central bank in transition, nevertheless, has to be looked at from the perspective of an institution that itself must be transformed, a point already made in Chapter II. Namely, the central banks under socialism mainly accommodated enterprises' needs for credits in line with the established production and financial plans. The role of money under socialism was therefore passive, as was the role of the central bank (cf. *monetary activism*).

But, with the start of transition, the central bank's position and tasks changed with society's needs and preferred policy outcomes, requiring active central bank participation. Formally, adjustments to these new socio-political and economic circumstances materialised through institutional changes, that is, through alterations in central bank legislation (i.e. adoption of new objectives, instruments, etc). In reality, active central bank participation is sought *via* behavioural changes in the approach to central banking. Whereas the main goal of formal modifications to central bank laws is to secure the central bank's *legal* independence (functional, institutional, personal, and financial), *actual* central bank independence only becomes evident when the central bank law is implemented and monetary operations conducted. Together, the legal and behavioural changes aim at securing the desired central bank attributes: accountability, transparency and credibility, as explained in Chapter II.

The purpose of this chapter is to disclose the economic and political circumstances in which the central bank law was modified in Serbia (i.e. Yugoslavia) over the last 15 years (1989-2003) in order to substantiate our initial thesis that during this period the central bank of Serbia shared the country's gloomy faith. Also, we will calculate the 'Cukierman index' of legal central bank independence on the basis of the current NBS law, as one of the most commonly used indices of central bank legal independence.[1] Additionally, based on Dvorsky (2004), we will assess the existing drawbacks in current Serbian central bank legislation *vis-à-vis* the relevant EMU requirements already elaborated in Chapter IV. We hope to be able to answer the question of how these institutional characteristics relate to the past monetary and exchange rate experience and what mechanisms (including *acquis*) could be used in the future to upgrade the NBS's credibility, found to be chronically lacking for years.

5.2. Transitional Central Banking Experience: Legal Aspects (1989-2003)

According to Cukierman (1992, p. 5) "institutions such as the legal framework within which policy operates are important determinants of policy outcomes." We shall substantiate this hypothesis by dissecting Serbia's central bank institutional legacy into four parts, depending on the timing of the introduction of a new central bank law: (i) Law on the NBY of 1989[2], (ii) Law on the NBY of 1993[3], (iii) Proposal of the Law on the NBY of 2002[4], and (iv) Law on the NBS of 2003[5] (to be analysed in the next section). The analysis should unveil the relationship between the adopted legal framework and the central bank's credibility, which ultimately determines the capacity of monetary policy to respond to short-term disturbances and to maintain low inflation (see Goodhart, 1993).

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[1] The second most widely used index for the measurement of central bank independence is the Grilli-Masciandaro-Tabellini (GMT) index (see Dvorsky, 2000).

[2] The full title of this law is the Law on the National Bank of Yugoslavia and on the Uniform Monetary Operations of the National Banks of the Republics and the National Banks of the Autonomous Provinces, Official Gazette of the SFRY, No. 34/89. We will refer to the law as the Law on the NBY of 1989.

[3] Law on the National Bank of Yugoslavia, Official Gazette of the FRY, No. 32/93.

[4] Law on the National Bank of Yugoslavia was drafted by the NBY and sent to the parliament in April 2002 (Ref. Ac. 272/1), but was never enacted for the reasons explained later in the text.

[5] Law on the National Bank of Serbia, Official Gazette of the RS, No. 72/03.

Our analysis will discern the following aspects of central bank independence: (1) functional independence, (2) institutional independence, (3) personal independence, and (4) financial independence. The separation, as well as the entire content, of each of the economic expressions of central bank independence is based on Dvorsky (2004), who uses the Treaty requirements as a yardstick. Additionally, we will look at some features of central bank accountability, as a means of counterweighting to the notion of independence (see Padoa-Schioppa, 2000).

The *functional* independence relates to the necessity for a central bank to have a single objective, namely the achievement of price stability. This, however, does not mean that the central bank should ignore other economic policies. Thus, legislation on the central bank should also include a secondary objective of supporting the implementation of those policies, under the condition that it does not jeopardise the fulfilment of the primary objective. *Institutional* independence depends on a number of considerations such as: the formulation and implementation of monetary policy, freedom from instructions, legality and statutory independence, and the selection of exchange rate regime. Similarly, *personal* independence relies upon the ways in which the role, status and composition of the highest decision making bodies are regulated. In other words, personal independence is measured *vis-à-vis* the appointment and dismissal procedures and their respective criteria, the length of the governor's mandate, the possibility of its renewal, professional competence requirements, and an incompatibility clause. *Financial* independence has two aspects. The first is a budgetary aspect that depends on rules guiding the management of the central bank budget (financial plan), ownership issues, allocation of profits, and coverage of the bank's losses. The second aspects relates to the prohibition of the monetary financing of public entities either through the form of direct credits or through the acquisition of their securities on primary markets.

Accountability is defined as "the legal and political obligation of an independent central bank to justify and explain its decisions to the citizens and their elected representatives (see ECB, 2002b, p. 45)" (Dvorsky, 2004, p. 64). Here, the elements of the central bank accountability include: mutual participation at meetings between government and central bank officials, appearance before the parliament, reporting requirements and the publication of meeting minutes.

5.2.1. Law on the NBY of 1989

Unlike many other transitional economies, the SFR Yugoslavia, of which the Republic of Serbia was a constitutive part, did operate a two-tier banking system well before the transition towards a market economic started. According to Šević (1996, p. 25), it was in the period from 1961 to 1971 that the National Bank of Yugoslavia was assigned a role in: (1) issuance of the dinar, (2) extension of credit, and (3) foreign exchange operations, which other banks in the system could not perform. In line with this, Chowdhury *et al.* (1990, p. 637) claim that the National Bank of Yugoslavia was the formulator of monetary policy since the reforms of 1965 and that "it is a central bank with functions and arrangements similar to central banks in market economies (see OECD, 1987; Hauvonen, 1970)". It should be emphasised, though, that a two-tier banking system in SFR Yugoslavia was *segmented*, in comparison to the *fully-fledged* two-tier banking systems common in market economies (see Hilbers, 1993). In other words, the banking system of SFRY comprised of a number of large banks – each of which dominated a specific segment of a market (e.g. agriculture, foreign trade)[6], especially after the late 1970s. No competition among these 'specialised' commercial banks really existed in the lending market, nor were they conducting their business on profit-maximising principles (see also Section 3.2.3).

Chapters III and IV revealed that under such a setting the money supply was determined endogenously, i.e. that the National Bank of Yugoslavia did not have control over the money supply. Chowdhury *et al.* (1990) write that this occurrence was, in fact, the result of the existing contradictions built into the institutional framework: "In particular, the state has conflicting goals–to promote macroeconomic stability and growth and to "mediate [enterprise] competition for investment resources" (Gedeon, 1985/6, p. 219)" (Chowdhury *et al.*, 1990, p. 637). The accompanying observation is that the NBY was not pursuing an active monetary policy, which in itself was an important legacy of the monetary institutional order of SFRY, and *inter alia*, of Serbia.

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[6] Šević (1996, p. 24) notes that in the period 1955-1961 a number of 'specialised' banks were established in SFR Yugoslavia including: Yugoslav Foreign Trade Bank [*Jugoslovenska banka za spoljnu trgovinu*] (established on 24 June 1955), Yugoslav Investment Bank [*Jugoslovenska investiciona banka*] (established on 12 July 1956), and Yugoslav Agricultural Bank [*Jugoslovenska poljoprivredna banka*] (established on 27 June 1958).

The specificities of the SFR Yugoslavia were reflected in the institutional arrangements of its central monetary authority: the country in fact had an atypical, decentralised *system of central banks* of republics and autonomous provinces.[7] The Law on the NBY of 1989 is, therefore, particularly interesting because it was the first central bank law introduced as a part of a greater 'transitional package', but was at the same time the last central bank law in Yugoslavia that recognised this complex system of central banks. One would expect that such a law – as a part of a reform plan – would delegate more power to a central bank, which was envisaged to have a major role in the process of transition. But, obviously, this could not happen in the political circumstances in which a "decadent, decentralised (defederalised) bureaucracy" prevailed (Šević, 1996, p. 28).

As a result, the new law brought only some minor changes, thus preserving the inefficient uniform monetary system. That the law was still retrograde in terms of delegation of powers and in securing the central bank's independence can be illustrated by the following few points. Firstly, in relation to the central bank objectives and monetary policy formulation, the law empowered the SFRY Assembly to "set the objectives and tasks of the common monetary and foreign exchange rate policy and of the common foundations of credit policy" upon the proposal of the NBY (Article 2(1)). In addition, Article 2(3) of the law prescribed that – within the given framework of objectives and tasks of the common monetary and credit policy – basic instructions about the channelling of reserve money, the discount rate of the NBY and the interest rates, would be determined by the SFRY Assembly.

Secondly, it would appear the NBY was seemingly given the possibility to independently introduce the implementation measures of the above-mentioned objectives and tasks, as foreseen by Article 2(4). A simple reading suggests that the NBY did have the instrument independence. However, Article 10(3) prescribed in detail the 'measures' to which the NBY could resort in implementing a common monetary and credit policy. The only exemption was foreseen by Article 10(4) saying that, owing to its responsibility for currency stability, the NBY could use additional measures if the monetary effects of foreign currency transactions departed from the set monetary targets.

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[7] According to Šević (1996, p. 27), such system existed since 1972 until *de facto* 1991, formally until 1993. Moreover, Šević (1996, p. 27) argues that with the adoption of the new SFRY's constitution in 1974, the NBY was no longer the single issuer of the domestic currency.

Moreover, the law of 1989 did not clearly stipulate the objective; it only prescribed that these (many) objectives should be assigned to the central bank by the Federal Assembly. What makes this approach unique is that currency stability was established as a policy objective by this law in a rather *implicit* manner (Article 10(2,4)). A conclusion thus can be drawn, that in the period 1989-1993 when the new law on NBY was in force (see discussion below), the National Bank of Yugoslavia did not enjoy the goal (functional) independence nor the instrument (institutional) independence.

Regarding personal independence, the 1989 Law inaugurated the Board of Governors and Governor as the National Bank of Yugoslavia's governing bodies (Article 77).[8] According to Article 78 of the law, the Board of Governors consisted of the NBY governor and of the governors of the national banks of the republics and autonomous provinces. Interestingly, the law envisaged both the collective responsibility of the Board of Governors and the individual responsibility of "each one of its members" *vis-à-vis* the SFRY Assembly in line with Article 78(2).[9]

For his work, the governor was accountable to the SFRY Assembly (Article 88), which appointed him (Article 89). Also, the appointment of a Deputy Governor and one or more Vice Governors was too in the hands of the Federal Assembly (Article 90(3)), although the law did not explicitly make them accountable to it or any other body. Interestingly, the law was also silent about the term of office of the members of the Board of Governors, their professional qualifications and appointment procedure.[10] On the other hand, Article 78(3) empowered the SFRY Assembly to propose the initiation of dismissal procedure to the republican parliaments, if in the process of 'political control' found the members of the Governing Board 'responsible' (criteria unknown). All thus points to the existence of strong political influence by the republics, and a low corresponding personal independence, of the NBY's officials.

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[8] The law stipulates that the Board of Governors shall decide by a simple majority except in certain cases (drafting laws or by-laws, adoption of NBY's financial plan and balance sheet, decisions concerning mandatory reserves, interest rates and the volume and rate of increase in credits granted to banks) when it should decide by a two-thirds vote of the total number of its members (Article 81(1,2)).

[9] In the case of ECB, the ECB Governing Council is only held accountable collectively (see Dvorsky, 2004, p. 67). The issue is related to the question of whether just the outcome or the detailed minutes of the meetings of the highest decision-making body are published. According to Article 10(4) of the E(S)CB Statute, the proceedings of the ECB Governing Council meetings are confidential, although the Governing Council may decide to make them publicly available.

[10] Those issues are regulated by the laws on the national banks of the republics and autonomous provinces.

In financial terms, the NBY Board of Governors was obliged by Article 103(1) of the law to prepare the NBY financial plan and annual financial statement, and to submit these to the SFRY Assembly for ratification. The NBY was required to use realised revenues to ensure resources for the: (1) fixed assets fund, (2) special reserve fund, and (3) working community (i.e. employees) of the NBY (Article 100(2)). Similarly, the remainder of gains accumulated after covering for accumulated exchange rate losses were to be transferred to special reserve fund (Article 101(1)). The rest of net revenues were to be allocated to the federal budget (Article 104(1)). At the same time, the law prescribed that only the expenditures of the NBY, which arose from the operations performed for the account of the Federation, would be covered from the federal budget (Article 102).

This *ex ante* control over the NBY budget, representing an infringement of the central bank's independence, was accompanied by another aspect of central bank financial dependence – lending to government. According to Article 52(1), the NBY could have granted credits to the Federation under the conditions prescribed by a separate federal law. "Notwithstanding the provisions of the first paragraph of this Article, the NBY may also grant short-term credits to the Federation for the purpose of bridging over time delays between the inflow of revenues and the financing of expenditures of the federal budget" (Article 52(2)). In fact, no limits were placed on direct central bank lending to government and, thus, the financial independence of the NBY was inexistent.

The fact that the NBY was also obliged to provide credit and to perform other banking operations "for the needs of the Yugoslav People's Army, and for other requirements of national defence" in conformity with the Article 53(1) by itself generated further market distortions. In particular, the law stipulated that a special People's Army Service be formed *within* the National Bank of Yugoslavia (Article 53(2))[11]. The law proscribed for the possibility of using short-term central bank credits for the financing of enterprises producing armaments and military equipment (Article 55(2)). Ironically, the NBY was given the right to determine the terms and conditions for the use of credits for military purposes, as per Article 55(3).

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[11] The specialised organisation operated under the name of *Narodna banka Jugoslavije – Vojni servis* [National Bank of Yugoslavia – Military Service], and it had been given the status of a legal entity by Article 53(2) of the NBY law.

Although not independent, the NBY was certainly held to account by the Federal Assembly to which it had to submit, at least twice a year, a report on the implementation of the common monetary and foreign exchange policy, on the policy of foreign credit relations, the common foundations of credit policy (Article 7), and on the control of banks and enterprises (Article 65). In line with the same article, the NBY was obliged to submit its annual balance sheet jointly with its annual report. Whether this also meant that the Governor was invited to appear before the parliament and use the opportunity to express his views and concerns is unclear. Still, while the relationship with the Federal Assembly was transparent, the form of cooperation between the NBY Governor and the Federal Executive Council was blurred. Namely, Article 86(2) stipulated only that the Governor "shall cooperate" with the FEC, without clarifying what form of cooperation the legislator had in mind.

To all this, one should add the complexity of relations between the National Bank of Yugoslavia, six republic national banks, and two autonomous provinces national banks. The 'federal system' of central banks, either national or supranational, though, is not necessarily inferior to a single central bank model as such. The US Federal Reserve System and the European System of Central Banks exemplify this point. What was different in the SFRY's system of central banks is that: (i) there was no clear supremacy of the NBY over the issuance of money and monetary policy, and (ii) the NBY and the national banks of republics and autonomous provinces were not exempted from the exertion of political influences.

We believe that the design of the NBY legislation itself greatly contributed to such a situation. In relation to this, one cannot ignore the fact that it was under this law that that the republican national banks intruded into the monetary system in 1990 and 1991 (see Section 3.2.4.1) – the primary motive being of a political nature, despite the fact that this was taking place in the face of war. The episodes of 'spectacular intrusions into the monetary system' confirm that the NBY's *actual* independence was practically non-existent. Moreover, the above analysis unveils a very low level of *legal* NBY independence as assigned to it by the Law on the NBY of 1989.[12]

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[12] As a benchmark, we used the standard definition of variables as suggested by Cukierman (1992, p. 373-376), although we have applied them in a more intuitive and not in a strictly structured manner.

Before the new law on the NBY was adopted, the existing law was amended on several occasions.[13] From an economics point of view, the most interesting are the 'special' provisions made effective on 8 April 1993 – applied during the sanctions period. By those special provisions, the NBY was given the authority to set forth the maximum interest rates of banks and other financial organisations in line with the movements of the NBY discount rate (Article 108a(1)). Paragraph 2 of the same article stipulated that the NBY would determine the special conditions under which it would provide short-term credits to the banks. Next, the law allowed the NBY to oblige banks and other financial organisations to allocate a part of their financial resources into the projects envisaged by the economic policy of the country for a given year (Article 108a(3)). Finally, the last point of this article entitled the NBY to prescribe in which cases and under which circumstances legal entities that are *not* registered for the "conduct of banking operations" could allocate the excess of their financial resources.

We recall from Chapter III that 1993-1994 was a period of dynamic activity for the so-called pyramid banks. In view of their disastrous involvement and role which they had in "the great robbery of the people" (see Dinkić, 2000), it is suspicious that the National Bank of Yugoslavia needed the law to be changed and to introduce one or two 'special provisions' in order to be able to fight such serious misconduct. This suggests that: (1) the likelihood that the NBY was itself involved in the building of prices in line with the instructions of elected politicians, as suggested by Dinkić (2000), is high, and (2) the institutional framework of the NBY established in 1989 was indeed very weak in terms of NBY's independence and assigned competencies.

The failure to delegate more power to the NBY and to secure its independence greatly facilitated its malfunctioning at the beginning of transition. Had the NBY been more independent, we argue, the stabilisation results might have been better, preventing the deterioration of the federal state's credibility. The unwillingness of the republican authorities to give up a part of their (monetary) sovereignty turned out to be calamitous. Consequently, this supports our earlier conclusion that the political consensus on reforms – which must include central bank reform and the distribution of power – is a necessary precondition to any successful stabilisation and transition.

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[13] Official Gazette of the SFRY, No. 88/89, 96/91 and 16/93.

5.2.2. Law on the NBY of 1993

The Constitution of the Federal Republic of Yugoslavia[14] of 27 April 1992 prescribed, in Article 114(1), that the National Bank of Yugoslavia is a single (legally) autonomous issuing institution of the FRY's monetary system, responsible for monetary policy, currency stability, financial discipline and other tasks as defined by federal law. The Implementing Law[15] stipulated that the Law on the NBY of 1989 was to be aligned with the Constitution by 31 December 1992. The deadline was missed and the new Law on the NBY was adopted with a six-month delay, on 25 June 1993. The new law was passed in difficult circumstances during which hyperinflation reigned and in which – in the words of the then Prime Minister of the FRY Government – "the macroeconomic policy was created and implemented on at least three levels [of government, auth. remark], which impeded its uniformity and efficacy".[16]

Delays in encircling of the FRY competencies, including the delay in the adoption of the new NBY law covering the monetary sphere, were among the institutional reasons behind the perilous state of the economy.[17] On the other hand, as evident from the statement by the Prime Minister, the 'endogenous factors' (i.e. the economic sanctions imposed on FRY) represented another major destabilising factor (FRYP, 1993b, pp. 5-7). Under the circumstances of an external blockade and severe internal shortages (especially of oil, medicine and some agricultural goods), the Federal Government took the view that the market could not optimally allocate those resources, and that thus state intervention was required (FRYP, 1993b, p. 7). Concurrently, however, the FRY Government did not want to give up ownership of the transition process, claiming that the transition towards a market-based economic model was its ultimate goal (FRYP, 1993b, p. 6). We believe that these evident inconsistencies and contradictions in the government's approach largely contributed to the severity of the economic crisis (see Chapter III), representing the background for the adoption of the new NBY law.

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[14] Official Gazette of the FRY, No. 1/92.
[15] *Ibid.*
[16] Extract from the statement of Mr. Radoje Kontić, Prime Minister of the FRY Government, delivered at the First Meeting of the First Extraordinary Session of the House of Republics (Upper House) [*Prva sednica prvog vanrednog zasedanja Veća republika*] on 16 June 1993 (FRYP, 1993b, p. 8).
[17] See FRYP (1993b, p. 9).

The first striking feature about the NBY Law of 1993 is that this law was completely silent on the central bank's objectives. Whereas the previous NBY law had left the formulation of NBY objectives in the hands of the SFRY Assembly, this law omitted to mention it completely. Instead, the new law only spoke of NBY *functions* (Article 1(2)). In describing those functions, the law (Article 1(1)) literally replicated the wording of Article 114(1) of the Constitution. The only addition was introduced by Article 1(2) stipulating that the NBY should contribute to the establishment of internal and external stability of the economy and its international integration.

Implicitly, it may be assumed that currency and financial stability were the main NBY objectives at the time. Having in mind, though, that the fulfilment of those functions (objectives) was to be pursued parallel with overall economic stability and international integration goals, one can detect potentially conflicting objectives, pointing to possible frequent policy preferences changes. One reasonable explanation, apart from the obvious constitutional constraints, is that the legislator wanted to leave the legal central bank framework sufficiently flexible in view of additional, unexpected disturbances. Even if true, we argue that such approach could only be counterproductive, as demonstrated by the disastrous record in monetary sphere in the period of the application of this law. The second and more likely reason behind such unusual language in the central bank legislation is that the NBY was subordinated to political influences.

The non-existence of the goal of (functional) independence did not automatically assume the absence of institutional independence. On the contrary, the law allowed the NBY to design and implement the monetary policy (Article 8). Even though we find that the provisions proscribing the competencies of the NBY in the monetary sphere (Art. 24 to 52) are overly detailed, the assurance remains that the NBY was indeed given functional independence by the law of 1993. This is seen as a substantial improvement in comparison to the previous NBY law of 1989 by which the NBY was refrained from the possibility to independently formulate the country's monetary policy. The solution, by which the NBY was obliged to cooperate with the Federal Government in determining exchange rate policy (Article 39), is also a step in that direction. The proposition by which the Federal Government was given the right to determine the actual exchange rate of the dinar upon the NBY proposition (Article 40) is, however, more ambiguous.

This law is also highly intriguing because it created the NBY Council as an additional governing body alongside the NBY Governor (Article 11), in spite of the fact that the FRY Constitution clearly stipulates that the NBY is governed by the Governor who is solely responsible for NBY operations (Article 114(2)). Even more dubious is the behaviour of legislators when the official opinion of the Secretariat for Legislation is taken into account. Namely, the Opinion on the Proposal of the Law on the National Bank of Yugoslavia, issued on 8 June 1993, clearly notes:

> "We point out that one cannot create by a law a new body – the NBY Council – which would be superior to the NBY Governor, because such an approach would run counter to the provision of paragraph 2 Article 114 of the Constitution. Namely, it is not arguable that by this law one can, besides the Governor, introduce another NBY body, but only if that body does not perform tasks that are by the Constitution conferred to governor, i.e. if it does not perform the tasks that are considered managerial, but only those assisting tasks such as counselling" (FRYP, 1993a, p. 5).

Nonetheless, the legislature adopted the law by which the NBY Council and Governor were established as governing bodies. Their competencies differed in that the Council was responsible for analysis and the adoption of decisions relating to the formulation of monetary policy and the overall functioning of the NBY (Article 14(1)), whereas the Governor was given executive authority over those decisions (Article 17(1)). Needless to say, even though the governor was a member of the Council by his position (one vote), the organisational model of the NBY ran against the Constitution. Formally, however, the FRY Constitutional Court recognised the unconstitutionality of the law only on 30 July 1999, a the full six years after the law's adoption, by assessing that Art. 11 to 15 and Article 17 of the NBY Law were incompatible with the FRY Constitution.[18] As a result, the aforementioned articles were repealed and so the NBY was left without a collective governing body. The entire NBY management was left in hands of only one person – the NBY Governor – thereby exacerbating the likelihood of both, a discretionary monetary policy and of political influence. This decision was made in the aftermath of the NATO bombing campaign, which raises suspicions about the judicial motivations in asserting protection of the constitutional order. The severity of the economic crisis itself (see Section 3.3.2) indicates that the political authorities might have been tempted to try to revive the economy by relying on monetary instruments and means (exclusively).

[18] Official Gazette of the FRY, No. 50/99; the Decision included remarks as those quoted by FRYP (1993).

At a more general level, this analysis suggests that the most senior legal act, i.e. the constitution, should include provisions on the position of the national central bank as well as articles about its governing bodies and their functional independence. Herein, it is of utmost importance that the constitution envisages the existence of the central bank's collective decision-making body, so as to prevent one single person from being responsible for the complex and demanding task of managing a central bank, as well as to protect it from the likely political pressures. In view of Goodhart's (1993) argument about the goal independence, we do not believe that the constitution should also explicitly refer to the central bank's objective(s). Rather, we propose that the central bank's objective(s) be unambiguously stated in the central bank's legislation. This conclusion is of special importance for Serbia, which is currently in search of political consensus for its new constitution (see Section 5.4.1), and for which this result is obliging.

In relation to personal independence, as seen already, the importance lies in the legal provisions dealing with the appointment and dismissal procedures of the governing bodies, as well as provisions stipulating their qualifications. In this respect, the Law on the NBY of 1993 offered hardly any clarifications. This law only stipulated the Governor's responsibilities *vis-à-vis* his daily operations and NBY management. Appointment and dismissal procedures were not specified and the law remained silent on the professional qualifications of the governor. However, the FRY Constitution prescribed that the Governor was to be elected for a five-year term with the possibility of reappointment (Article 114(3)). The Federal Parliament was given the authority to appoint the Governor (Article 78(7)) upon the recommendation by the FRY President and the opinions of the republican presidents (Article 96(4)), as well as to dismiss him.

Once again, the example of the FRY's constitutional provisions relating to the central bank requires a more general conclusion to be drawn. As already explained, the solution by which the position of the central bank governing bodies is defined by the constitution should, in principle, be welcomed. But, the idea of providing constitutional protection to a single person and, at the same time, exposing him to political pressures is untenable. In other words, this constitutional inconsistency was unsustainable and counterproductive in the application of the principle of the personal independence of a single central bank governing body.

With regards to financial independence, the Law on the NBY of 1993 stipulated in Article 14 that the NBY's financial plan was to be adopted by the Council. Thus, once this article was deleted in 1999, the governor resumed this responsibility (Article 70(2)), thereby preserving the NBY's financial independence as the determination of the financial plan remained in the hands of the central bank. However, this positivistic approach to financial independence diminished due to the lack of *ex post* control of the financial operations of the NBY, implying a shortage of the NBY's accountability. Also related to this was the requirement of the law to use the NBY's realised profits to ensure resources for the: (1) 'common spending' of the NBY employees, (2) fixed assets fund, and (3) special reserve fund (Article 68(2)). What remained was considered as part of federal budget's revenue (Article 68(3)), whereas any excess of expenditures over revenues were ultimately covered from the federal budget (Article 68(4)).

Nonetheless, the NBY was obliged to finance the FRY government and republican governments. This was done through the following: (1) the acquisition of governments' securities on the primary market (Article 26 (3)), (2) the purchasing of shares issued by public enterprises (Article 26(4)) after being guaranteed by the FRY or one of the constitutive republics, and (3) direct credits for the alleviation of temporary liquidity problems of the federal or republican budgets of up to 10 per cent of planned annual budget revenues at an interest rate that may be lower than the NBY discount rate (Article 34). The law also envisaged that the NBY should, exceptionally, during 1993 and 1994 (i.e. during hyperinflation years), extend short-term credits to the FRY and to the republics to help them maintain the liquidity of their budgets of up to 30 and 20 per cent of the planned annual federal/republic budget revenues, respectively (Article 92).

The variety of methods by which the NBY was obliged, under this law, to lend to government(s), represents a clear confirmation that the NBY was not legally independent from the executive branch of government in the period 1993-2003. Pairing this with the finding of Arsić *et al.* (2001) that from 1994 to 2000 the money supply was exogenous (see Section 4.4.1), we come to conclude that the NBY did not benefit from *actual* independence in this period either. The consequences were severe, as it was during this period that the NBY lost its credibility. The effects remain present today, and are evident in the high *de facto* euroisation of the economy (see Chapter IV).

Was the NBY Governor held accountable for this disastrous record? Formally, the NBY was required by Article 22(1) to submit to the Federal Parliament for *deliberation* an annual report about its performance and achieved results. Also, as per Article 22(3) the Governor was obliged to *inform* the Federal Parliament of his planned monetary policy programme for the coming year. Moreover, by Article 22(2) the National Bank and thus not the Governor personally had to *submit* to the Federal Parliament, on demand, but at least twice a year, a report on the state of its monetary policy and on the state of banking and the overall financial system. Finally, the annual NBY financial statement was to be *approved* by the Governor and *confirmed* by the parliament (Article 70(1)).

Questions such as what happens if parliament does not confirm the annual report, or what does the parliament do with the submitted monetary policy program or reports, were left unanswered. Furthermore, as with the previous law, this one did not contain provisions on the appearance of the NBY governor before parliament, including the possibility of the governor being heard by the members of parliament upon their request. Overall, the relationship between the highest (and only) NBY governing body and the elected representatives of the people was, by the Law on the NBY of 1993, vaguely and inconclusively set. Interestingly, however, this was not the case with the provisions that regulated the cooperation between the Federal Government and the NBY. Namely, Article 23 of the law prescribed that the NBY was to cooperate with the Federal Government on the establishment of the basic objectives of the economic policy and was to support, within the scope of its responsibilities, the implementation of those goals.

In reality, we observe some very symptomatic developments. Firstly, just twenty days after the promulgation of this law, Vuk Ognjanović, the then-Governor who happen to propose the law to the parliament, was relieved from duty and was replaced by Borisav Atanacković. However, only three months after the appointment Mr. Atanacković left and so the NBY did not have a governor for the following four and half months. Only on 2 March 1994, after the adoption of the anti-inflation programme, Professor Dragoslav Avramović was appointed the new NBY governor, a position he held for about two years. After the dismissal of Governor Avramović the NBY again did not have a governor for an entire year. Only on 26 June 1997 Dušan Vlatković was appointed but, not surprisingly, did not hold a full mandate, as he was dismissed on 27 November 2000.

Such a high rate of turnover suggests a very low *actual* independence of the central bank (see also Section 5.3.3), but could also serve as an indication of *genuine* central bank accountability in cases in which the central bank is headed by a single person.[19] We believe, however, that this hypothesis can only hold if the dismissal procedure for the governor is legally well-defined and transparent. Having in mind that the Law on the NBY of 1993 did not include such provisions, one cannot exclude the possibility that the high turnover rate of governors in the observed period reflects the effective exercise of political influence over NBY governors and not the level of their accountability. To speak further to this point: in the absence of formally defined procedures for the dismissal of a Governor, the answer to the question about the accountability of NBY's Governor also depends upon the politicians' *motives* that stand behind any dismissal decision. This would be a difficult undertaking in the best of circumstances, much less in those concerning a secretive government.

The assessment of this particular NBY law must also be made in view of the critical hyperinflationary state of the economy. We think that the institutional framework of the NBY of 1993 largely facilitated such developments. In particular, the delays in the institutional adjoining of competencies in the monetary sphere contributed to the excessive money supply and the NBY's loss of control over money creation (see Chapter III). Furthermore, the fact that the authorities did not use the new NBY law, introduced during the period of hyperinflation, to assign to the NBY a single explicit objective over the stability of prices, also supports our conclusion. Finally, all other solutions adopted as part of the law, such as low personal and financial independence, illustrate our argument.

The Law on the NBY of 1993, however, brought to an end a decentralised system of central banks, which existed in SFRY for years, by transferring the rights and obligations of the national banks of Yugoslavia (for the territory of FRY), Serbia, Montenegro, Vojvodina and Kosovo and Metohija to the 'new' NBY (Article 89(1)). This way, a 'unified monetary system' of central banks of the SFRY, ceased to exist and a new single monetary authority of the FRY was established.

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[19] According to De Haan, Amtenbrink and Eijiffinger (1998), one feature of the central bank accountability concept includes the final responsibility for monetary policy (see Section 2.5.2). This responsibility depends, among other things, on the dismissal procedures for the governor.

5.2.3. Proposal of the Law on the NBY of 2002

According to Bruno (1993, p. 269), the establishment or bolstering of central bank independence is an important component of stabilisation and structural reforms that aim at achieving internal and external balance. How is it, then, that the FRY did not initiate the adoption of a new central bank law as part of a stabilisation plan, the implementation of which resumed in December 2000?[20] Instead, having in mind that a new law was adopted only in July 2003, the reformist leadership of the NBY continued operating under the NBY law of 1993 throughout the stabilisation period. Only in late 2002 was the Proposal of the Law on the NBY submitted to the FRY parliament, which sought to introduce some modern approaches into the everyday operations of the NBY and to increase its independence. At least, this is what the NBY officials, who proposed this law, claimed at the time.[21]

Before we start scrutinising this Proposal, one other element should be commented upon. Specifically, we refer to the fact that the NBY Law of 1993 was applied throughout very heterogeneous sub-periods: (1) a period of hyperinflation and subsequent slowdown in economic activity, as registered from 1993 to end-2000, and (2) a period of stabilisation and re-birth of transition and structural reforms taking place from 2001 to mid-2003. Several conclusions emerge. Firstly, inadequate (vague, extensive or inexistent) provisions of the NBY Law of 1993 relating to the NBY's objectives, appointment and dismissal procedures, professional qualifications, lending to government and other issues, allowed for diverse interpretations to be used at different times depending on who was heading the NBY and who appointed that person. This leads to the second conclusion, that the institutional credibility of the NBY was weak or even lost and that it was occasionally substituted by the personal credibility of governors. In other words, we claim that all stabilisation efforts in FRY in the period 1993 to 2003 relied on 'borrowed credibility' and that the NBY during that entire decade lacked institutional credibility. The implications of these findings are considerable and require some normative response; thus, we shall turn to those issues at a later stage.

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[20] We assume that monetary stabilisation resumed after the appointment of the NBY governor Mlađan Dinkić on 28 November 2000, following the 'bulldozer revolution' of 5 October 2000 (see Chapter III).
[21] See Minutes of meeting held on 24 June 2003 between the NBY and the Ministry of Finance of the RS.

One possible reason that the reform package did not include the NBY law at the outset of stabilisation is that many within the ruling DOS coalition insisted on the establishment of a new Serbian Constitution, which supposedly needed to regulate the position of the National Bank of Serbia and its governing bodies differently than the FRY Constitution.[22] Also, after the signing of the Belgrade Agreement in early 2002, the work on the Constitutional Charter of SCG resumed and stretched over entire 2002 (see Section 3.1), offering the possibility for the removal of existing constitutional constraints.

However, as the tensions between the then-governor and the late Serbian Prime Minister Zoran Djindjić intensified (due to reasons explained below), the Federal Government suddenly decided to adopt the new NBY law.[23] The proposed law was never enacted by the FRY parliament, but we find that it is still important for our thesis as it: (i) unveils the intentions of the ruling coalition and their maturity in relation to the role of the NBY in the Serbian society, and (ii) provides an insight in the central bankers' reasoning, taking into account that the NBY drafted the proposal.

Even though it was based on the same FRY Constitution (re. Article 114) as the previous NBY law, this proposal unequivocally stipulated the 'achievement and maintenance of price stability' (Article 3) as the NBY primary objective. One can argue, however, that such a narrowly defined policy objective is too stringent given other macroeconomic objectives, which often accompany the primary objective, such as is the case with the ECB (Article 2 of the ESCB Statute). However, the proposal also included a provision by which the NBY was obliged to support the government's *economic* policy without prejudice to its primary objective and to cooperate with the government in formulating that policy (Article 77).

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[22] One should bear in mind that Montenegro began building its own independent monetary system in 1999 by adopting the Regulation on the use of the German mark as a means of payment in Montenegro (see Official Gazette of the RM, No. 41/99 and 22/00). The Regulation instituted a parallel currency system in Montenegro, which operated until January 2001 when the German mark became the single legal tender; in June 2002 marks were replaced by euros (see Fabris *et al.*, 2004, p. 30). The Law on the Central Bank of Montenegro was adopted in October 2002 (see Official Gazette of the RM, No. 52/00, 53/00 and 47/01).

[23] It is important to note that the then-NBY governor Mlađan Dinkić and the then Deputy Prime Minister of the Federal Government Miroljub Labus have belonged to the same think-thank *G17 plus*, which became a political party in mid-2003. Also significant is that the Federal Government at the time (2000-2002) did not have a Prime Minister and that Mr Labus was Acting Prime Minister.

Besides functional independence, the proposal also envisaged institutional independence for the NBY. Notably, Article 4 of the proposal prescribed that the NBY would be held responsible for the formulation and implementation of monetary and exchange rate policy, foreign reserve management, etc. With regards to legal status, the proposal re-instituted the NBY as a separate legal person (Article 5(1)) and went even further by proclaiming the NBY's statutory independence (Article 2(2)). Additionally, even though the economic literature has not unambiguously answered the question of whether the central bank has to be held solely responsible for the formulation of the exchange rate policy (Dvorsky, 2004, p. 57), the proposal gave the NBY exclusive competence over the determination of exchange rate policy and the exchange rate regime without an obligation to consult with the government (Art. 4 and 38(1)). On the other hand, the proposal indicated that the NBY would cooperate with the Federal Government and with other public institutions in the implementation of its functions, undertaking measures that would contribute to the enhancement of that cooperation (Article 10)[24].

Regarding personal independence, the proposal re-established the Governor as a single person responsible for the overall NBY functioning. Of course, there existed a clear constitutional constraint to introduce a collective decision-making body at the NBY. But, then, the question remains why did the Federal Government and the NBY officials insist on a new NBY law just a few months before the existing Constitution was to be replaced by the Constitutional Charter (adopted on 4 February 2003)?

The Governor was to be appointed, in line with the relevant constitutional provisions, for a term of five years, with the possibility of reappointment (Article 12(2)). In relation to the governor's professional qualifications, Article 13 stipulated that only a person of recognised standing and with over ten years of professional or academic experience in banking and finance, could be appointed as Governor. The Governor was also given the right to nominate his deputy and to nominate vice governors (Article 17(3,7)), make decisions about the acquiring and use of NBY assets (Article 86), special reserve fund (Article 80(2)), the NBY financial plan (Article 81(3)), and the selection of auditor (Article (82)), all of which point to a significant governor's autonomy.

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[24] This runs against the explicit prohibition for the ECB or any of the national central banks of the EU Member States, i.e. members of their decision-making bodies, to seek or take instructions from Community institutions or bodies, from any Member State's government or any other body (Article 7 of ESCB Statute).

It should be noted, though, that the proposal did foresee another NBY body – the NBY Supervisory Board – that was assigned an oversight function (Article 21). Considering the given constitutional constraints, this body was given quite numerous responsibilities as per Article 23(1,2). These included discussing issues, expressing views, formulating positions and proposing them to the governor. Also important was its role in informing the parliament in cases in which it perceived omissions in NBY management that led to a failure in achieving the primary objective (Article 23(4)). Nevertheless, the new NBY body was not given any competencies in the formulation and implementation of monetary policy and thus we shall not analyse its status and composition in detail. We note, though, that the proposal assigned to the Governor to recommend three out of five Board members, whose main task was to oversee his work.

As for the dismissal procedure, the proposed law (Article 15(1)) prescribed that the Governor could be released from duty prior to the expiration of his mandate only in the following events: (i) at his own request, (ii) if the Supervisory Board assesses that large omissions prevented the fulfilment of the NBY's primary objective, (iii) if convicted of a crime, (iv) serious illness, and (v) submission of a false statement about the incompatibility clause described in Article 18.[25] Article 15 prescribed that parliament would – upon receiving the information from the Supervisory Body about the Governor's misconduct – form a commission that would hear the governor's views. And, only if the commission assesses that reasons for dismissal exist, it would inform the parliament, which would then decide about governor's dismissal. Even though in itself the possibility of a governor appearing before a parliamentary commission is a sign of greater central bank accountability, it is not clear whether this solution is also consistent with the law.[26]

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[25] Therein, Article 18 envisaged that the governor, deputy governor, vice governors, members of the Supervisory Board and the entire managing staff of the NBY could not be members of federal/republican parliaments or governments, nor could they be members of managing or supervisory boards of banks, other financial organisations, auditing firms or any other institutions otherwise controlled by the NBY. Likewise, the article prescribed that they could not have shares or founding stakes in the above stated institutions . They were also required to submit a written statement to the Federal Parliament upon appointment. The proposed law also envisaged the so-called 'cooling-off' clause by which the governor, once dismissed from duty, could not be employed by a bank or any other financial institution operating at the territory of the FR Yugoslavia in a period of one year following his dismissal.

[26] It is not accordant to the comparative parliamentary best practices to prescribe by a law the establishment of a parliamentary commission when parliament already has a committee for financial affairs, whose task should be to oversee the work of the central bank. Besides, issues remain open such as the composition of such a commission (representative of ruling political parties, opposition parties, etc.), deadlines, *et similar*.

Having in mind that the NBY governor is a single-person decision-making body, one needs also to assess whether such a degree of autonomy for the Governor is balanced by his accountability. On this point, the economic literature asserts that such vast central bank independence is only sensible if counterbalanced with enhanced central bank accountability (see Padoa-Schioppa, 2000). The proposed law explicitly stipulated in Article 12(3) that the governor would be held accountable by the Federal Parliament (statutory accountability); but, the actual appearance of the governor before parliament was required only in the context of a possible dismissal. No appearance before parliament was envisaged concerning the governor's regular duties or for the presentation of the monetary policy annual report and the report on the state of banking and on the overall financial system for the previous year (Article 76)[27].

Likewise, the obligation to publish these reports was not stipulated, pointing to a low level of NBY transparency. Moreover, the law did not regulate mutual participation in meetings with government or, more importantly, the publication of a rationale behind the Governor's decisions. This last point, we find, is of particular concern, given that there was no collective decision-making body in the NBY at the time and that some mechanism was needed that would enable control over the governor's work. Therefore, the conclusion appears that the proposed law regulated *ex ante* control of the NBY's conduct only in a vague and unsatisfactory manner.

In addition to the above-mentioned governor's autonomy relating to the so-called 'budgetary independence', the proposal also prescribed that potential NBY losses were to be covered from the federal budget. Concerning lending to government, Article 33 of the proposal prescribed that the NBY could extend credits for the purpose of alleviating a budget's temporary liquidity problems. Interestingly, this was the only article in which the Federal Government was not explicitly mentioned, suggesting that credits could have been extended also to the republican governments. Similarly, the NBY was given the possibility to acquire government securities on the primary market as per Article 28(1): "the NBY conducts open market operations by buying and selling securities". This may be related to the acquisition of public sector securities, as well.

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[27] In the case of the EU, it is the ECB President who has to present those reports to the European Parliament even though Article 15(3) of the ESCB Statute does not explicitly say so. This article, however, is based on Article 113(3) of the Treaty, which obliges the ECB President to present the reports himself.

The analysis discloses a number of points. Firstly, it identifies a tendency on the part of the NBY's officials who drafted the law to fully exploit all the conceptual and practical expressions of a central bank's independence. To put it differently, we uncover a strong pro-independence bias on the part of the NBY officials. At first, this may seem usual, but it is not necessarily so given the level of propensity for independence not detected in the NBY law of 1993 that was also drafted by the NBY. We are, however, aware of the possible methodological inconsistency deriving from the fact that the Law on the NBY of 1993 was actually adopted by the parliament, whereas the Proposal of the Law on the NBY of 2002 did not. Thus, it could have been difficult to distinguish between the intentions of the NBY officials and the legislature, having in mind that any proposed law may be substantially altered in the course of parliamentary debate. Our conclusion here, therefore, is based on the investigation of the Proposal of the Law on the NBY of 1993, which was drafted by NBY staff.[28] Analysis confirmed that the proposed version did not differ considerably form the enacted version, thereby substantiating our assessment.

Secondly, the incorporated NBY accountability clauses proved to be an inadequate counterbalance to the NBY's substantial independence. In this, the NBY's accountability should only be considered within the given NBY governing model. The set context, a rather peculiar one, as given by the Law on the NBY of 1993, establishes the governor as the sole source of policy. This fact – although deviant from standard central bank managerial models in which a collective governing body exists – illuminates another, unelaborated expression of central bank independence. In particular, the one in which the need arises to either limit the central bank independence, or to strengthen the central bank's accountability – because of the existence of a single-person central bank governing body. To put it differently, it may be that a Walsharian-type principle-agent contract would appear ineffective in overcoming the observed central bank propensity towards exploiting the allotted independence in case of a single-person central bank governing body at the cost of public accountability.[29]

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[28] See the NBY letter to the FRY Assembly dated 26 May 1993 (Ref. X/402/93).

[29] Nothing conclusive can be said about the susceptibility of FRY's legislators towards such approach in case of this particular law proposal, as one cannot assume to what extent the FRY parliament would have modified the proposed NBY law. But, there may be other cases were this idea would need to be followed.

5.2.4. Concluding remarks

The conducted analysis substantiates the universality of postulates relating to central bank independence, demonstrating that Serbia is not a 'special case'. What was special about the country in terms of its central banking business is the persistence of a democratic deficit originating from the highest state act – the Constitution (27 April 1992 – 4 February 2003).[30] This act placed constraints relative to central bank governance in that it stipulated the existence of a single-person source of policymaking, i.e. Governor.

The implications of such a solution are potentially devastating, both in legal and real terms, as was evident from the example of the National Bank of Yugoslavia Law of 1993. The Yugoslav monetary experience in the period 1993-2000, as well as certain sub-periods characterised by hyperinflation, supports this claim. On the other hand, however, the period of macroeconomic stabilisation registered from 2001 to mid-2003, during which the NBY continued operating under the aforementioned law, demonstrates the existence of a fallacy concerning central bank independence, as observed by McCallum (1995). This points to the fact that central banks need not always exploit inflationary expectations. To resolve this conflict a simple solution should be adopted, namely the delegation of authority for monetary policy to a collective policymaking body.

Also indicative is the pattern by which changes in political preferences influence the monetary policy conduct, regardless of the institutional changes of the central bank framework. The example of Serbia's successful stabilisations of 1994 and 2001-2003 during which, as we found, moderate *legal* central bank independence existed, may serve to illustrate the point. We conclude that, ultimately, the behavioural characteristics of central bankers and their policy preferences (not those of politicians) are the most important critical factor that determines the inflation record. The individual credibility of persons holding positions of prominence in a central bank is what decisively determines the monetary policy demeanour. How this individual credibility can be translated into long-lasting institutional central bank credibility is a question seeking attention.

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[30] Here, we refer to the FRY Constitution because it provided the legal basis for the Law on the National Bank of Yugoslavia of 1993 with monetary competencies extending to the Republic of Serbia. By this law (Article 91), the National Bank of Serbia was established as a branch of the NBY and did not have monetary sovereignty. Thus, our analysis relates to the NBY and FRY Constitution. We shall, however, analyse the Constitution of the Republic of Serbia of 1990 in the next section.

5.3. Current State of Monetary Governance in Serbia: Some Evidence

The degree of central bank independence (CBI) has increased worldwide in the past few decades (see Dvorsky, 2004). In this, the transition economies have been no exemption, demonstrating a great inclination for increased central bank independence. This is evident from numerous works dealing with the subject (see, for example, Cukierman, Miller and Neyapti, 2000; Dvorsky, 2000). The reason behind such occurrences is rooted in the belief that central bank independence is beneficial for macroeconomic stability and, in particular, for price stability (see Cukierman, 1992).[31]

The case for increased legal central bank independence in the transitional economies of Central and South East Europe has additionally been strengthened by the prospective of EU membership. Chapter IV presented the main requirements in the area of Economic and Monetary Union, which also include the provisions on central bank independence. Clearly, any country wishing to join the EU has to align its central bank legislation with those requirements prior to accession. This fact has been the main driving force for the transitional economies to adapt their central bank legislation with that of the EU, which eventually resulted in increased legal central bank independence in those economies. Obviously, the countries that joined the EU on 1 May 2004 have already completed this task, whereas the Western Balkans countries still have a way to go.

As a result, our analysis is primarily based on the assessment of the degree of legal harmonisation with the EMU requirements on central bank independence in the case of Serbia. Additionally, we shall calculate the Cukierman index of *legal* and *actual* CBI, which is in some aspects stricter and in some ways weaker than the EMU requirements. Such evidence still does not exist for Serbia, as the country was typically excluded from such studies (see, for example, Cukierman *et al.*, 1998). The rationale behind this exercise is to place Serbia into the broader context of transitional countries with which then it can be compared. Therefore, the combination of those two approaches will provide an empirical foundation for a discussion about the state of monetary governance in Serbia, which has so far largely been based on political grounds.

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[31] Alessina and Summers (1993), as explained in Chapter II, found that legal central bank independence is almost perfectly negatively correlated to the countries' inflation record. This study, however, only relates to a sample of industrial countries.

5.3.1. Law on the NBS of 2003

The law on the National Bank of Serbia enacted in mid-July 2003, which is currently in implementation in the Republic of Serbia (without Kosovo and Metohija), is of special interest to our study for several reasons. Firstly, it gave back to Serbia its monetary sovereignty which the country had lost in 1920. As a consequence, this law placed the National Bank of Serbia into a broader historical context.[32] Secondly, the law endowed the National Bank of Serbia with a high degree of independence, which it had never had before (see Dugalić, 2003; Šević, 1996). Thirdly, it brought Serbian central banking practices much closer to EMU requirements, although additional alignments will be necessary. The analysis that follows corroborates our claims.

Still, the professional and general public will most probably remember this law because of the protracted political disagreement between the Serbian Prime Minister and the NBY governor on the one hand, and between the Serbian Minister of Finance and Economy and the NBY governor on the other, which accompanied the process of adoption of this law.[33] Those political quarrels greatly blurred an objective assessment of the economic concepts embodied in the law. So far, the law has been judged mainly on political grounds, which we find inappropriate. We thus offer an alternative approach by placing the discussion within the context of the actual institutional circumstances in which this law was born. Namely, with the adoption of the Constitutional Charter of the SCG and the accompanying Implementing Law on 4 February 2003, the constitutional restraints that existed in the FRY Constitution in relation to the central bank were removed. Consequently, the new constitutional reality prevailed.

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[32] Dugalić (2003, pp. 24 and 27) explains: "The National Bank was constituted by the act of adoption of its Statute at the constitutive session of 29 February 1884, and so that date should be celebrated as the date of the Bank's establishment. [...] The explained organisational scheme of the National Bank was kept until the end of the World War I. Then, the reconstruction of this issuing institution was done and its transformation into the central bank of the newly formed state dates from 1 February 1920 when it was turned into the National Bank of the Kingdom of Serbs, Croats and Slovenes. In 1929 it becomes the National Bank of the Kingdom of Yugoslavia. After World War II it becomes the National Bank of the FNRY [Federal People's Republic of Yugoslavia, auth. remark], then the National Bank of the SFRY, and as of 1992, the National Bank of the FRY. After almost 119 years, on 4 February 2003 [...] it becomes the National Bank of Serbia [...]". The date 4 February 2003 is, however, debatable and it will be explained later on.

[33] At the time, the Serbian Prime Minister was Dr. Zoran Djindjić, the Minister of Finance and Economy was Mr. Božidar Djelić, whereas the NBY governor was Mr. Mlađan Dinkić. After 12 March 2003, when Mr. Djindjić was assassinated, Mr. Zoran Živković took the position of Prime Minister, but disagreements with the Governor continued. See *Ekonomist*, No. 153/154, 28 April 2003 and No. 160 dated 16 June 2003.

The Implementing Law stipulates that the National Bank of Yugoslavia (as well as some other former FRY institutions) shall continue operating as the institution of the Republic of Serbia from the date of enforcement of the Constitutional Charter, in accordance with the legislation by which it was constituted and which will remain applicable in Serbia until replaced by new legislation (Article 13(1)). Thus, the National Bank of Yugoslavia was to retain its legal status until the adoption of a new Law on the National Bank of Serbia, due to the fact that the NBY Law of 1993, which was to remain in force, established it as the National Bank of *Yugoslavia*, not as the National Bank of *Serbia*. However, in the spirit of Serbia's traditional penchant for intricacy, the following Article 14(4) of the Implementing Law refers to the NBY as to the National Bank of Serbia by specifying: "The function of the payment agent shall, on behalf of the member states, be performed by the National Bank of Serbia and the Central Bank of Montenegro". Expectedly, the relevant provisions of the Implementing Law were interpreted differently and, consequently, political tensions rose again.[34] We, nevertheless, tend to believe that the National Bank of Serbia was established on the day of the adoption of the Law on the NBS on 18 July 2003 and will thus refer to this date in our further analysis.

Once the FRY Constitution was abolished, the legal basis for the adoption of the central bank law in Serbia was to be found in the Constitution of the Republic of Serbia[35]. In particular, the Serbian Constitution stipulates that the Republic of Serbia has a National Bank (Article 107(1)), and that the status, organisation, management and conduct of the National Bank is regulated by law (Article 107(2)). Such modest provisioning is based on the fact that the Serbian Constitution was adopted in 1990, while the FRY Constitution was still in effect and that, at the time, the National Bank of Serbia[36] had only been a branch of the National Bank of Yugoslavia.

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[34] See, for example, the letter sent by the Republican Secretariat for Legislation to all government members (dated 20 February 2003) in which the Secretariat express its opinion: "Regarding the paragraph 4 of Article 14 of the Law [Constitutional Charter Implementing Law, auth. remark], we stress that the mentioned provision (as well as the paragraph 1 of the same Article) does not have the transitory character, but substantive [...]. Therefore, it [the provision, auth. remark] relates to the period following the constitution of the bodies of Serbia and Montenegro, i.e. after the adjustments of monetary regulations of the member state Serbia with the Constitutional Charter".

[35] Official Gazette of the RS, No. 1/90.

[36] The National Bank of Serbia ceased to exist on 16 July 1994 by adoption of the Law on Repealing of the Law on the National Bank of Serbia (Official Gazette of the RS, No. 45/94).

Nevertheless, the Serbian Constitution provided a firm legal basis for the adoption of a new NBS law. This time, however, the new law on the NBS was not drafted by the NBS's staff, but by the Serbian Ministry of Finance and Economy, i.e. the government, which later on proposed the law to parliament. This point, in combination with a high degree of NBS independence (see the analysis below), demonstrates the reformist character of the Serbian parliament and government in the period 2001-2003. If we recall from Chapter III that during this period overall macroeconomic stabilisation was achieved (not only monetary stability), we can presume that pro-reformist governments tend to delegate more autonomy to their central banks than less-reform oriented ones.

As soon as the circumstances allowed, i.e. once the new constitutional framework was set and the Republic of Serbia formally took over the responsibility for monetary policy, the Serbian government decided to reform the central bank's legal framework as proscribed by Article 20(4) of the Implementing Law. The adoption of new National Bank of Serbia legislation in the second half of 2003 also was part of the financial sector structural benchmark agreed with the IMF under the Extended Arrangement.[37] At that point, the main aim was to bring legislation on the central bank in line with the EMU's principles and requirements as much as possible. A restraining factor in this exercise was the actual (fragile) state of the economy, banking and entire financial sector.

In contrast to previous Serbian central bank legislation, the new law ensures the NBS's functional independence. In particular, Article 3(1) explicitly stipulates that the primary objective of the NBS is to achieve and maintain the price stability. Additionally, Article 3(3) introduces a secondary objective, that is, support to the implementation of the government's economic policy, on the condition that it does not jeopardise the fulfilment of the primary objective and only if it is based on the principles of a market economy. Yet, in view of the unreformed financial system, Article 3(2) envisages that the NBS "besides its primary objective, also has the maintenance of financial stability as its objective". Dvorsky (2004) notes that such a formulation may create a potential conflict between the objectives. We, however, think that the primacy of the price stability objective is guaranteed by the actual wording ('besides its primary objective').

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[37] See Letter of Intent on Memorandum of Economic and Financial Policies for Serbia and Montenegro under the Extended Arrangement (Annex D) of 11 July 2003 [Available at: http://www.imf.org/external/np /loi/2003/yug/01/ 040103.pdf].

In relation to institutional independence, again, more then any previous central bank law in Serbia (Yugoslavia), the NBS Law of 2003 delegated authority over monetary policy to the NBS. Several provision s speak to this assertion. For example, Article 5(1) establishes the NBS as a legal entity clearly separated from other government institutions and bodies. Likewise, in the introductory provisions of the law, Article 2(2) clearly institutes the NBS as autonomous and independent in the conduct of its functions, thereby securing the NBS's statutory independence. Moreover, in line with European standards, the law prohibits the NBS to take or seek instructions from "government bodies or other persons" (Article 2(3)). The formulation might look slightly ambiguous as it refers to 'other persons'. However, the original Serbian version reads *drugih lica*, which in Serbian legal jargon includes not only individuals (*fizička lica*), but also legal entities (*pravna lica*). What is missing, although it might as well be assumed, is the shield from the exertion of different forms of influence (see Section 5.4.2) and the prohibition to take or seek instructions from parliament. In addition, as will be explained later, the protection against the possible influence of the EU institutions or bodies should as well be envisaged in view of the future E(M)U membership.

Also related to institutional independence is the authority of the central bank to formulate and implement a country's monetary policy. Thus, the NBS Law of 2003 formally prescribes the responsibility to design and implement Serbia's monetary policy to the NBS (Article 4). Even though the functions of the NBS are explicitly listed and precisely defined by the law, the Bank is left with the possibility to perform other tasks if these are not contrary to its primary objective (Article 34(11)). As regards the selection of an exchange rate regime and the conduct of an exchange rate policy, the situation is less clear-cut. Namely, Art. 4(2) and 43 envisage the NBS's autonomous command of the dinar exchange rate *policy*, but prescribe that the dinar exchange rate *regime* is to be determined with the government's consent. Thus, it is difficult to say anything conclusive about the NBS independence in this respect. One possible interpretation is that the NBS, in fact, has obtained independence over exchange rate management, as the role of the government in this is largely consultative. On the other hand, our interviews with the high NBS officials revealed that such a solution diminished the NBS's ability to adhere to its primary objective by prompt changes in the exchange rate regime.

The situation concerning the role, status and composition of the highest governing bodies and their personal independence shows great improvements in comparison to the NBY Law of 1993. Most importantly, the NBS Law of 2003 introduced a collective policy-making body – the Monetary Board (Article 12(1)) – whose members are the governor and vice governors of the National Bank of Serbia (Article 13).[38] Additionally, the law establishes the NBS Council (Article 12(3)) as a supervisory-type board, which consists of five members (the president of the Council and four other members).[39]

The selection procedure assumes the appointment of a Governor by the Serbian parliament for five-year term, with the possibility of a renewed mandate (Article 16). At the same time, although it is usual practice for the government to nominate at least some of the members of the highest governing body of a central bank (see Dvorsky, 2004, p. 57), the entire authority was in this case delegated to the Governor, who was to propose all Vice Governors (Article 19(2)). Additionally, the Vice Governors are to be appointed by the NBS Council (Article 19(2)), which is in itself an uncommon practice.[40] The reasoning behind such an approach may be found in the legislature's readiness to relinquish more authority to Governor in choosing his closes associates and its willingness to only indirectly influence his choice by appointing the Council members (Article 23(2)). Besides, having in mind that the professional requirements, which apply to the (Vice) Governor also apply to the members of the Council (Article 23(3)), it is likely that the Serbian parliament in this way wanted to 'import' the necessary expertise needed for the personnel selection of an adequate Monetary Board. Those requirements are given in Article 16(2) and relate to: (i) fulfilment of general employment requirements, (ii) possession of university degree, (iii) working experience in the fields of economy, finance and banking, and (iv) a recognised academic or professional reputation.

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[38] According to Article 19(1), the National Bank of Serbia has three to five vice governors.

[39] The Council was not termed a Supervisory Board for two reasons mainly: (i) as to avoid any association with the corporate structure of enterprises, and (ii) not to create misleading impressions about the functions of the Council, which also have other roles apart from those relating to the supervision.

[40] A comparative analysis of the central bank laws of Bulgaria, Macedonia, Montenegro, Romania, and Slovenia, shows that vice governors were indeed in most cases appointed by parliament. The analysis includes the following laws: Article 12 of the Law on the National Bank of Bulgaria (1997), Article 72 of the National Bank of Macedonia (2002), Article 14 of the Law on the Central Bank of Montenegro (2000), Article 34 of the National Bank of Romania (1998), and Article 36 of the Law on the Bank of Slovenia (2002). In contrast, the inspection of Article 10 of the Law on the National Bank of Poland (1997) and Article 7 of the Law on the National Bank of Slovakia (1992) reveals that vice governors are appointed and recalled by President.

The Law on the NBS of 2003 is peculiar in its governor nomination procedure. Namely, due to the constitutional restraint by which the President of the Republic of Serbia does not have the responsibility to nominate Governor, the legislature opted for a solution by which the governor is appointed by the Serbian parliament upon the proposal of the Parliamentary Committee for Financial Affairs. A similar solution, for example, exists in Croatia.[41]

Regarding the criteria for being removed from office, Dvorsky (2004, p. 59) writes that "legislated reasons have to be unrelated to central bank policy and limited to exceptional circumstances clearly defined by the law". The same author, however, observes that by 31 October 2004, none of the SEE central banks were fully compatible with such requirements. This relates to Serbia, too. Namely, as a result of prolonged hyperinflationary periods and frequent periods of high inflation during the 1990s (see Chapter III), and the finding that such episodes were the result of the central bank's immense engagement in 'printing money', those provisions were strengthened in the 2003 NBS Law.

In particular, causes for dismissal are numerous and the same for all members of the Monetary Board and the Council. They include criminal offence, misconduct, false statements, professional incompetence, and inability to perform one's duties (Article 30). Additionally, the dismissal procedure for the Governor assumes that the Council will affirm the existence of any of the reasons for dismissal and will initiate the procedure before the Parliamentary Committee for Financial Affairs (Article 31(1)). In the phase of the assessment of those reasons, the parliamentary committee has to hear the Governor's statement (Article 31(2)). If the committee judges that causes for dismissal exist, it informs the parliament, which decides on the Governor's dismissal (Article 31(3)). So, on the one hand, the law lists more than the necessary potential reasons for the governor's dismissal which may decrease his personal independence but, on the other hand, establishes a balance by giving the governor the right to appear before the parliamentary committee and by ensuring that those reasons are not subject to discretionary judgments.

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[41] In particular, Article 40(1) of the Law on the National Bank of Croatia (adopted on 5 April 2001) prescribes that governor of the Croatian National Bank shall be appointed by Croatian parliament upon proposal by the Administrative Parliamentary Committee and with the accompanying opinion of the Parliamentary Committee for Finance and State Budget.

In the case of vice governors, pretty similar mechanism exist. Notably, Article 31(4) prescribes that governor determines whether there exist reasons for the initiation of dismissal procedures for vice governors and informs the NBS Council of his findings, which rules on the matter. It should be added that the law also provides for a "cooling-off" period of one year following the date of expiry of the governor's , vice governors's and the Council members terms during which they cannot exercise any function at banks and other financial organisations (Article 33). Had the NBS been given the oversight authority over the insurance companies at the time of this law's adoption, the aforementioned provision would, most likely, have included a "cooling-off" period for insurance companies.[42] Interestingly, however, even though such specification does not represent a formal EMU requirement, it has been incorporated in several SEE central bank laws (see Dvorsky, 2004).

Also, for the first time in history, the NBS Law of 2003 regulated in considerable detail the so-called 'incompatibility clauses'. Those incompatibility clauses are generally welcomed as they prevent the exercise of political influence and the emergence of conflict of interest. The NBS law, thus, proscribes that the members of the Monetary Board and NBS Council cannot be: parliament and government members, high political party officials, local government and trade union members, company managing or supervisory boards' members, external advisors to banks, other financial organisations and auditing firms or any other legal entities which the National Bank supervises or with which it cooperates in the performance of its functions (Article 28). Article 85 goes even further by setting forth that all employees of the NBS as well as Council Members cannot be guided by their political beliefs in the conduct of their jobs.[43]

Even though rather strict and detailed, these incompatibility clauses still somewhat clash with EMU standards[44] in that they still do not preclude the members of the National Bank of Serbia's highest decision-making bodies (the Monetary Board and Council Members) to engage in some other gainful or non-gainful activities and would thus need to be adjusted.

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[42] The NBS was given the authority to supervise the insurance companies on 29 May 2004 by the adoption of Amendments to the Law on the National Bank of Serbia (see Official Gazette of the RS, No. 55/04).
[43] In this, it should be noted that governor and vice governors are full-time employees of the National Bank of Serbia (Article 22), whereas the Council members are external specialists (Article 27).
[44] See Article 11(1) of the ESCB Statute, which refers to members of the ECB Executive Board.

Before moving to an analysis of different aspects of the financial independence of the NBS under the current law, it is necessary to assess the appointment procedure of the NBC Council members. Article 92(3) envisages a staggered appointment procedure for the Council members implying a varying length of term for each of the Council members. The Council President is to be appointed for a term of five years, whereas the other four members are to be appointed for a term of four, three, two and one year, respectively. In this way, the legislature additionally strengthened the resistance of the Council members to possible political influences by one parliamentary majority *via* the separation of Council members' length of terms (1-5 years) from the regular electoral cycle (4 years).

In the field of the central bank's financial independence, the NBS Law of 2003 brought some significant improvements, but also failed to fully align all provisions with the highest EMU standards. It is worth nothing, however, that those standard options were considered, but rejected on the following two grounds: (1) the financial and budgetary position of the country was such that it did not allow for the absolute prohibition of government lending from the NBS (no single treasury account was established, not all budgetary revenues were fully consolidated, the market for government securities was fully developed, etc.), and (2) an assessment was made that the central bank also needs to be reformed (cut in the number of employees, containment of salaries, etc.).

Therefore, in the search for *optimal* solutions, the legislature opted for limited direct central bank credit to the government for the purpose of covering temporary budget liquidity difficulties. Those direct credits are restricted to 5 per cent of the average budget revenues of the past three years, whereby the total outstanding credit cannot exceed the tripled amount of minimal proscribed capital and asset reserve fund of the NBS (Article 39). Regarding the prohibition against the acquisitions of government securities on the primary market, Dvorsky (2004, p. 61) finds that those are left unregulated. We, however, point to Article 36 stipulating that the NBS implements open market operations (i.e. primary and secondary market operations) by trading the assorted securities which it deems appropriate (based on quality, maturity, etc). Even though the NBS did not conduct such operations in the period mid-2003 to mid-2005 (as stated by the NBS vice governor in our interview), it is by the law not forbidden to do so.

Nonetheless, the securities issued by the Republic of Serbia in January 2005, based on the Law on the Settlement of Obligations of the Republic of Serbia to the National Bank of Serbia[45], were *transferred* to the National Bank of Serbia. Namely, the aforementioned law (Article 2) stipulates that securities are to be issued against: (1) old NBY's purchases of government bills worth 17 billion dinars, (2), old NBS's purchases of the public electricity company's (*Elektroprivreda Srbije*) shares equalling 1,899 billion dinars, and (3) old credits and associated interest arrears (cut-off date 31 December 2004) that the NBS extended to the Republic Commodity Reserves Fund in the amount of 802 million dinars.

This act, in its substance, represents the acquisition of government securities on the primary market, but as it is based on some *previously* extended credits it takes the form of debt rescheduling. Also, one should bear in mind that exactly this transaction enabled the NBS to start operating repurchase operations, giving a momentum to the development of the Serbian financial market for government securities. Altogether, this one-off operation should be treated as exclusive and should thus not be considered as a demonstration of government influence over the central bank independence.

With regards to another aspect of the NBS financial independence, it should be noted that the NBS Law of 2003 introduced an unusual form of *ex ante* control of the NBS's financial plan. In particular, Article 24(1) stipulates that the NBS financial plan is to be adopted by the NBS Council upon the governor's proposal. At first, it seems that the financial independence of the NBS has been secured due to the fact that the NBS body was entitled to determine its expenses and revenues autonomously (see Dvorsky, 2004). Nevertheless, having in mind that the Council members are in fact external experts, one may question the NBS's genuine independence *vis-à-vis* the rules guiding the management of the central bank's budget. Similarly, the provisions on the NBS's loss coverage by the issuance of government debt securities (Article 77(5)) are questionable and incompatible with the Treaty (Dvorsky, 2004, p. 62). Equally, the transfer of realised revenues to the state budget as envisaged per Article 77(4) is inconsistent with the EMU requirements, as it is seen as a form of central bank lending to government. On the other hand, the governor's right to manage the special reserve fund (Article 78) is welcomed.

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[45] Official Gazette of the RS, No. 135/04.

To counterbalance the increased NBS's independence, the NBS Law of 2003 also strengthened its accountability. The most profound difference introduced by this law, as compared to previous central bank legislation, concerns the mutual participation in meetings. Notably, Article 45(6) envisages that the Finance Minister participates in the Monetary Board meetings, though without a voting right. Also, Article 72(1) gives the governor the possibility to attend government sessions if the agenda includes issues related to the implementation of the NBS's objectives and the performance of its functions. Moreover, Article 10 stipulates that the NBS cooperates with the government and the rest of the state apparatus within the limits of its competencies. Although this provision resembles that of Article 86(2) of the NBY Law of 1989, which we criticised, the context in which this clause appears in the NBS Law of 2003 is rather different; notably, it specifies this cooperation by the above-mentioned articles.

Besides, a wide set of mutual consultations is envisaged by Article 72(2,3) according to which the Finance Ministry sends its draft laws and by-laws, including the draft Budget Law and the draft memorandum on budgetary, economic and fiscal policy to NBS experts for their opinion. Contrary to the previous NBY laws, the NBS was not given the possibility to directly propose regulations to the Serbian parliament, but was instead given the right to initiate the adoption of laws relating to the implementation of its functions by suggesting to the government that it propose those laws to parliament (Article 72(4)).

Also related to the central bank's accountability are its reporting requirements. The current NBS law proscribes the following reporting obligations:

- The Governor submits to the Council a report on monetary policy conduct, issuance and withdrawal of banking licenses, and bank supervision, at least a week before each Council meeting (Article 18);
- The Council submits to parliament a report on its performance at least once a year (Article 26);
- The NBS submits to parliament its monetary policy programme for the following year, for information purposes only, by 15 December of the current year, which is to be *published* in the Official Gazette within a month (Article 71(1,5));

- The NBS submits to parliament a report on the conduct of its monetary policy, including the explanations of all factors which have influenced it, by 30 June of the following year (Article 71(2));
- The NBS submits to parliament an annual report on the situation in banking and overall financial sector by 30 September of the following year (Article 71(3)); and
- The Council submits to parliament the NBS annual report together with an audit report by 30 June of the following year, which is to be *published* in the Official Gazette within a month (Article 79(2,3)).

This quite extensive list largely matches EMU requirements.[46] One particular provision, however, was criticised by Dvorsky (2004, p. 66) on the grounds that "*ex ante* coordination on the monetary policy programme between the central bank and the parliament [...] may jeopardize CBI". We nevertheless argue that, as long as the monetary policy is to be submitted to parliament for 'information purposes only', there does not exist 'coordination' and, *inter alia*, a risk of parliament influence. Moreover, if one takes into account the general character of the monetary policy programme, which traditionally has been used to proclaim the NBS's targets and goals without any detailed elaboration about the means to achieve them, the scope for potential political influence additionally narrows.[47]

The analysis largely supports our initial claim that the NBS Law of 2003 gave the National Bank of Serbia greater independence. We tend to believe that this observation is even more important having in mind the adverse collective and institutional experience from the 1990s, involving the misuse of central bank operations for political purposes. At the same time, however, we argue that the uncovered conservatism, as reflected in the conference of greater independence to the NBS, has also been a reason for the cautious approach to the central bank's accountability that is detectable in the current law.[48]

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[46] See Article 113(3) of the Treaty and Article 15 of the ESCB Statute.
[47] See, for example, the Decision on Monetary Policy in 2003 (Official Gazette of the FRY, No. 71/02).
[48] This is evident in the several fields: introduction of a secondary objective (maintenance of the financial stability), variety of reasons for removal from office, existence of cooling-off provisions, staggered appointment procedure for the Council members, limited central bank lending to government (although not prohibited), quasi-*ex ante* control of the NBS financial plan, inability of the NBS to propose laws directly to parliament, dynamic coordination with the government and parliament, substantial reporting, etc.

It is interesting to compare this with our earlier findings. Namely, the analysis of the results of monetary and exchange rate policy in Serbia during the past 15 years has already made us conclude that society in Serbia perceives an approach to monetary management as *credible* if that approach is also *conservative* (see Section 4.4.2). Rogoff's (1985) theory implies that an institutional response to such a situation should include high central bank independence. The analysis here reveals that such a motive indeed existed at the time of adoption of the current NBS law. Our analysis, however, also unveils that the opportunity to fully exploit the concept of central bank independence, i.e. an opportunity to assign to the NBS even higher autonomy, did not materialise. One can argue that this is because of the Serbia's degree of democratic and economic development and that more independence will only be assigned to the NBS once the overall political and economic state of affairs in Serbia improves.

In principle, the conferred central bank independence is considered beneficial as it is expected to affect the rates of expansion of money and credit. But, that the legally independent central bank cannot by itself suppress negative macroeconomic tendencies is confirmed by Serbia's somewhat weaker economic performance, which was registered in 2004 (see Chapter III) when this law was already in effect. Clearly, close coordination with other policies is needed if the macroeconomic (monetary) stability is to be sustainable as well. It cannot be excluded, though, that this point may simply represent a reflection of Cukierman's (1992) conclusion that time is needed for legal central bank independence to be translated into actual independence. The period of implementation of this law is too short to allow any conclusive statement to be made at the time of writing.

Also, some of the solutions applied in this law collide with the formal EMU requirements and would thus need to be further harmonised. However, in this, one should have in mind that De Haan *at al.* (1998) found the ECB, which is entirely compatible with the EMU requirements, to have a rather low level of democratic accountability. Thus, we argue that the inspected increased accountability of the NBS policy-making bodies *vis-à-vis* the highest elected body is well-balanced given the country's economic strength and democratic development. Still, though, the final assessment on the appropriateness of the applied approaches can only be made after an empirical measurement of the legal and actual NBS independence is conducted.

5.3.2. Measuring the legal CBI in Serbia in period 1989-2005

It is easy to believe that the central bank's *legal* independence does not correspond fully to the central bank's *actual* independence as demonstrated in practice. This is a result of the fact that no central bank law can take into account all possible real-life contingencies. High legal central bank independence, nonetheless, ensures that the risk of any of these contingencies realising is reduced. It is, therefore, important for a law to contain provisions securing a high degree of central bank independence. Herein, independence should not be mistaken with the authority of the central bank's decision-making bodies to do whatever they please, but it should assume that the central bank has autonomy to pursue its price stability objective independently from other branches of government (see Cukierman, 1992, in Chapter II).[49]

Actual central bank independence is difficult to calculate because it depends not only on legal independence but also "on a myriad of other less structured factors such as informal arrangements between the bank and other parts of government, the quality of the bank's research department, and the personalities of key individuals in the bank and other economic policymaking organs like the Treasury" (Cukierman, 1992, p. 369). As a result, most efforts to quantify CBI have focused largely or exclusively on the measurement of *legal* central bank independence.[50] Our decisions to compute the NBS's legal independence is motivated by the fact that Serbia was excluded from the existing studies so far. The availability of such data would enable comparison with other (transition) countries and would point to improvements, which took place since the 1980s when the first such index was calculated by Cukierman (1992) for the NBY.

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[49] The two notions are quite often mistaken in Serbia, even among governors. For example, governor Dinkić had claimed on several occasions during the first half of 2003 that the government had been drafting a law that was to drain away his independence as a governor. The analysis of the NBS Law of 2003 has shown that this was not so and that the NBS independence was not in any way diminished. In fact, we argue that quite the opposite happened; that the central bank was granted even more independence then before. The misunderstanding, possibly, also derived from the fact that this law introduced a collective NBS decision-making body as opposed to the previous situation in which only the governor was deciding about everything as a single-person governing body of the National Bank of Serbia. Besides, we believe that the concept of central bank *independence* was confused with the concept of central bank *accountability* in this particular situation as well because the NBS's increased accountability was interpreted as loss of the NBS independence.

[50] See, for example, Grilli, Masciandaro and Tabellini (1991), Curierman (1992), Cukierman, Miller and Neyapti (2001), Dvorsky (2000).

Our analysis will be based on the codification system for measuring legal central bank independence developed by Cukierman (1992), making it compatible with the data presented in earlier studies on former socialist economies (Cukierman, Miller and Neyapti, 2000) and Dvorsky (2000)[51]. As any other calculation of CBI, this analysis cannot, by any means, be absolutely secluded from subjective assessments and judgements about certain legal provisions related to the construction of the CBI index. This subjective element enters the process of the measurement of CBI in the part relating to interpretations about the legislature's intensions. It should be stressed, however, that those interpretations also differ due to translation and that, occasionally, the spirit of the law is lost unintentionally. It is thus important to note that in this particular case the index will be constructed based on the original, *Serbian version* of the law and that the assignment will lean on existing knowledge about the real intensions behind the formal provisions of the law.[52]

The Cukierman index comprises 16 coded variables (based on legal descriptions), which are split into four groups: (1) chief executive officer, i.e. governor, his appointment and dismissal procedure, term of office and incompatibility clauses (code=CEO), (2) policy formulation, including competence to formulate policy, central bank participation in the budget process and potential conflict with government (code=PF), (3) central bank objectives (code=OBJ), and (4) limitations on lending (code=LL). The definitions of legal variables and their coding are presented in Appendix 1. In this, each of 16 variables is assigned a numerical code (scoring) between 0 and 1, where 0 corresponds to the smallest level of independence and 1 to the highest level of independence. This analysis covers 15 years (1989-2003). The time span is divided into three groups: (1) 1989-1992, the period during which the NBY Law of 1989 was in effect, (2) 1993-2002, the period of application of the NBY Law of 1993, and (3) 2003-2005, the period of implementation of the NBS Law of 2003. For the sake of comparison, we shall also calculate the CBI index for the Proposal on the NBY Law of 2002, but this should be treated with caution as this Proposal was never adopted by the parliament.

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[51] Dvorsky (2000) used a combined methodology, but we believe that results can be used for comparison.

[52] The author was a member of the Ministry of Finance and Economy Working Group which drafted the law on the National Bank of Serbia in 2003 and is aware of the rationale behind some provisions. This, however, does not imply that some other information, besides those contained in the NBS law, will be used. On a contrary, we shall rely on information given by the law, as suggested by Cukierman (1992, p. 371).

The overall index for each sub-period is obtained by computing: (1) an un-weighted mean (LVAU), and/or (2) weighted index (LVAW). Data obtained are presented in Table 5.1. The most sensitive part of this exercise is the one relating to the assignation of numerical codes to actual legal provisions. As most other aspects of this assignment, it is relatively subjective because it relies on individual interpretations of certain legal provisions. For all those legal provisions where dilemmas existed about which code to assign to it, we feel obliged to offer explanation and additional comments. For the rest of legal variables, which are found to be straightforward, no detailed elaboration is needed.

Table 5.1. *Definition of legal variables and their numerical codings*

VARIABLE	NUMERICAL CODINGS				
	1980-1989	**1989-1992**	**1993-2002**	**2002 Proposal**	**2003-2005**
Chief executive officer (CEO)	**0.3325***	**0.3325**	**0.4575**	**0.625**	**0.625**
Term of office (too)	0.25	0.25	0.50	0.50	0.50
Who appoints (app)	0.25	0.25	0.50	0.50	0.50
Dismissal (diss)	0.83	0.33	0.83	0.50	0.50
Other offices (off)	0	0	0	1	1
Policy formulation (PF)**	**0.033***	**0**	**0.250**	**0.250**	**0.333**
Who formulates (monpol)	0	0	1	1	1
Final authority (conf)	0.2	0	1	1	1
Role in budget (adv)	0	0	0	0	1
Central bank objective (OBJ)	**0.400***	**0.400**	**0.400**	**1.000**	**0.600**
Objectives (obj)	0.40	0.40	0.40	1	0.60
Limitations on lending (LL)	-	-	-	-	-
Advances (lla)	0	0	0.66	0.66	0.66
Securitized lending (lls)	NA	0	0	0	0
Terms of lending (ldec)	0	0	0.66	1	0.33
Potential borrowers (lwidth)	0	0.33	0.33	1	1
Limitations on lending (lm)	**0.25***	**0.25**	**0.310**	**0.270**	**0.5175**
Type of limit (ltype)	NA	NA	0.33	0.33	0.66
Maturity of loans (lmat)	0	0	0.66	0	0.66
Interest rates (lint)	0.25	0.25	0.25	0.75	0.75
Primary market (lprm)	0	0	0	0	0
Index 1 (LVAU, un-weighted)	**0.13**	**0.16406**	**0.38343**	**0.90437**	**0.50818**
Index 2 (LVAW, weighted)	-	-	**0.50187**	-	**0.62337**

Notes: * Author's calculations; the rest in that column provided by Cukierman (1992). NA – no account.
** For weights used in the construction of index see Cukierman (1992, pp. 379 and 380).

Source: Author; column for 1980-1989 is based on Cukireman (1992, pp. 396-411).

In relation to the NBY Law of 1989, we decided to assign a code 0.33 to the dismissal variable (*diss*) even though the FRY Assembly did not itself have a jurisdiction over the governor's dismissal. Although it seems that Article 78(2) envisages dismissal based only on policy reasons, the next paragraph (Article 78(3)) stipulates that the FRY Assembly could, based on 'political control', propose to a republic's parliament to dismiss the governor (Article 78(3)). We, therefore, assigned code 0.33 relating to "unconditional dismissal possible at *republic* legislative branch's discretion", as ultimately the legislative arm had the last say in the dismissal procedure. In relation to authority over the resolution of conflicts (*conf*) we assigned code 0 based on Article 81(4), but also having in mind Art. 66(3) and 55(3). As regards the central bank's objective (*obj*) we assigned 0, as price stability objective appears only implicitly, as do a number of other NBY objectives, task and functions (see, for example, Article 75). In relation to terms of lending (*ldec*) we assigned code 0 on the grounds of Article 52(1) implying that terms of credit are set by a federal law. Similar provisions exist also in Article 55(3). As for the type of limit (*ltype*) we used NA as there is no account of relevant provisions in the law. However, equally, the code could have been 0 in view of the fact that the lending limit did not exist at all. Concerning the maturity of loans (*lmat*), the code is 0 based on Article 52(1) and not 0.66, although in Article 52(2) the maturity of loans is limited to one year. The reasoning behind such decision is that Article 52(2) applies only in "exceptional circumstances".

In relation to the NBY Law of 1993, we chose to allocate 0.83 to the dismissal procedure (*diss*) instead of 1, which relates to situations in which there are no dismissal provisions, because the Governor can be dismissed for non-policy reasons (i.e. incapability or violation of law) on the basis of a labour code (Article 79). We assigned numerical code 1 to the variable on final authority (*conf*), although Cukierman's description does not fit perfectly in the part concerning "clearly defined in the law as CB objectives" simply because the law does not define those objectives clearly. Regarding type of limit (*ltype*) code is 0.33 and not 0.66 even though in Article 34(2) the limit relating to central bank liabilities existed, because during 1993 and 1994 the NBY could extend credits without limits. In the case of interest rates (*lint*) we assigned 0.25 despite Article 34(4) stipulating that interest rates may be lower then the NBY's discount rate.

Finally, with regards to the NBS Law of 2003, we chose to assign code 0.50 for dismissal procedure (*diss*) as we treated the false statement as a law violation. We applied the same reasoning in relation to professional qualifications. *A propos* the central bank's advisory role in the formulation of the government's budget (*adv*) we assigned code 1 based on Article 72(3) and by analogy to Cukierman *et al.* (2000)[53] who assigned 1 to Poland based on the Law on the National Bank of Poland[54] from 1997 (Article 23(1)), by which PNB was given the possibility to issue opinion on government budget. In relation to advances (*lla*), we assumed these to include only direct credits and thus assigned code 0.66 to this variable and code 0 to the variable on securitised lending (*lls*). For the type of limit (*ltype*) the selected code was 0.66, because the limit given as percentage of NBS capital has primacy over other limit, which is set as percentage of government revenues (Article 39(2)). Concerning interest rates (*lint*), the code is 0.75 based on Article 41(5) assuming that this article also regulates advances to government.

The results obtained are telling. A cross-sectional (i.e. over time) evaluation of those results reveals a steady increase in legal central bank independence in Serbia (Yugoslavia) over the last 25 years. In this, the smallest improvement in legal CBI is registered in 1989, in comparison to the preceding period (1980-1989). This implies that the legislature was unwilling to delegate more power to the National Bank of Yugoslavia at that time. Having in mind that the NBY Law of 1989 was a part of the overall reform package, this finding places doubts on how genuine the intentions of political actors was to transform the country and to fight high inflation.[55] We recall from Chapter II that 1989/1990 marked the period of the beginning of transition in SFR Yugoslavia. The code of 0.16 of the CBI's legal NBY independence in the early years of transition in comparison to a mere 0.13 for the period 1980-1989 reinforces our earlier finding (see Section 5.2.1) that introduced institutional central bank changes did not bring any substantial improvements in terms of the NBY's independence.[56]

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[53] See Table A1 in Cukierman *et al.* (2000, p. 33).
[54] Published in *Dziennik Ustaw*, No. 140/1997 (item 938).
[55] According to Petrović and Vujošević (2000, p. 499), "The former Yugoslavia [SFRY, auth. remark] experienced high inflation in the 1980s, which slowly built up through mid-1980s and surged after 1987 from a 118% annual rate to as much as 1256% in 1989, reaching monthly rates of 50% in the last quarter of 1989 and thus, according to Cahan (1956), entering hyperinflation". See also Chapter II.
[56] Even though the indices used reflect the legal CBI of different central banks, the NBY of the SFRY and the NBY of FRY, we allow for the comparison based on Cukierman *et al.* (2000, p. 14).

The NBY Law of 1993 adopted during the period of Slobodan Milošević's ruling shows substantial advancement in terms of legal CBI. However, it should be noted that this high increase in legal CBI came mainly from Serbia's low initial position. In particular, the LVAU index indicates increase from 0.16 to 0.38. Interestingly, when compared to other transitional countries, the LVAW index of 0.50 for Serbia (Yugoslavia) corresponds to the LVAW index of, for example, Albania (based on law from 1992, LVAW=0.51), Bulgaria (law from 1991, LVAW=0.55), the Kyrgyz Republic (law from 1992, LVAW=0.52), Latvia (law from 1992, LVAW=0.49), Mongolia (law from 1996, LVAW=0.55), Russia (law from 1995, LVAW=0.49), and to the average legal CBI in transition economies after central bank reforms (LVAW=0.52).[57] As far as the international comparison is in question, we find that the legal CBI index LVAU of 0.38 generally matches with the LVAU index (median) of 0.33 from a sample of 68 developed and less developed (LDCs) countries during the 1980s.[58] Simplified, this means that Serbia in the period until 2003 had a level of CBI independence as developed and LCDs had in 1980s, indicating that the central bank reform in the country was delayed for at least a decade, if not for two decades.[59]

However, that this index of the central bank's legal independence does not fully illustrate the actual situation is evident from our previous analysis, which pointed to the existence of hyperinflation in the period 1992-1994. This also shows that the legal CBI may not necessarily always be exploited and that some other, less structured factors, also play a role, as noted by Cukierman (1992). One should not forget, though, that in the period of enforcement of this law (from mid-1993 to mid-2003) Serbia also experienced a period of successful stabilisation (2001 to mid-2003). The existence of those temporal variations in inflation in the period of enactment of this law does not conform to unaltered legal central bank independence. Consequently, we may extend the conclusion by Curkierman *et al.* (2000, p. 4) – that central bank reform and the consequent higher legal central bank independence are unrelated to inflation – to Serbia, too. However, additional studies will be needed to empirically confirm the absence of this relationship.

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[57] Data from Cukierman *et al.* (2000, p. 8), see Table 1.
[58] See Cukierman (1992, p. 380).
[59] This is so having in mind that during 1980s when the average legal CBI index LVAU stood at 0.33, the SFR Yugoslavia had twice smaller CBI (i.e. LVAU was 0.13).

As evidence suggests, the Law on the National Bank of Serbia adopted in mid-2003 conferred substantial legal independence to the Serbian central bank. The legal CBI index LVAU of 0.51 shows a fine improvement in comparison to the NBY Law of 1993 for which this index stood at 0.38. Such a degree of legal central bank independence happens to be fully in line with the rest of the transitional experience. Notably, the LVAW index of 0.62 corresponds to the average LVAW index of 0.63 for transitional countries (Cukierman *et al.*, 2000, p. 9), as registered after the second round of the central bank institutional reform that took place in the second half of the 1990s. However, such a result does not match with the general tendency of latecomers to transition to enact laws with higher levels of independence (see Cukierman *et al.*, 2000). Once again, we believe that this stems from the fact that Serbia had a very low starting position and that the state of the economy was rather poor as a result of 1990s' mismanagement. An obvious consequence is that the NBS could not have been given too much autonomy.

In comparison with other transitional countries, it appears that Serbia (LVAW=0.62) currently holds the same rank that Slovenia (LVAW=0.63) and Slovakia (LVAW=0.62) did before they introduced final changes into their central bank laws in order to fully align with the EMU *acquis* in the last few years. Also noticeable is that Serbia is above the SEE regional average that stood at 0.48 (excluding Bosnia and Herzegovina) based on central bank laws that were in effect in those countries up to 1998 when this index was calculated.[60] On the other hand, Serbia is lagging behind the ex-socialist countries that became EU members on 1 May 2005 and that had already well before the actual EU membership (at least 5 years before) largely aligned their legal CBI with that of the ECB. Their average LVAW index, calculated on their central bank legislation introduced until 1989, stood at 0.70 (Cukierman *et al.*, 2000, pp. 36 and 37).[61] This pattern demonstrates that the prospect of EU membership, which is open for Serbia too, encourages politicians to give more independence to the central banks.

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[60] For Albania LVAW=0.51, for Bulgaria LVAW=0.55, for Croatia LVAW=0.44, for Macedonia LVAW=0.41, and for Romania LVAW=0.34 (Cukierman *et al.*, 2000, pp. 36 and 37). It should be noted, though, that in a number of SEE countries, the same central bank laws are still in effect. See, for example, the Law on the Bank of Albania (effective from 23 December 1997). Available at: www.bankofalbania.org

[61] In this, only Latvia with the LVAW index of 0.49 was well below the average, whereas Slovenia and Slovakia, which we already mentioned, as well as Hungary with the LVAW of 0.67 stood below the average. For the rest of countries in this sample LVAW was 0.73 for the Czech Republic, 0.78 for Estonia, 0.78 for Lithuania and 0.89 for Poland (Cukierman *et al.*, 2000, pp. 36 and 37).

The inspection of specified legal variables of different laws, which existed over the last 15 years, demonstrates that the legislature in Serbia has traditionally been reluctant to delegate more independence to the central bank's Governor (CEO in Cukierman's terminology). Thus, we only register a slight, although, steady improvement over the years. A similar situation is observable for a variable that measures the terms of central bank lending to government, which indeed doubled in mid-2003, but from a very low base. In order to additionally improve the NBS's independence, issues such as an explicit prohibition of the central bank to lend to the government or to purchase government securities at the primary market will have to be regulated by the NBS law. On the other hand, it seems that the idea of leaving a central bank solely responsible for autonomous formulation and implementation of policies has finally matured in Serbia, as MPs allotted full autonomy to the NBS with the latest changes of the law in 2003. In relation to the definition of the central bank objectives, the analysis reveals that there has been considerable confusion. We believe that this reflects society's changing preferences, as well as constitutional alterations, but that also it can be attributed to the transition from one socio-economic setting towards another one. That the transition in Serbia decisively resumed after October 2000 is also confirmed by these alterations.

Relatively modest improvements in some areas of legal central bank independence over the last 15 years once more point to conservatism, which has remained ingrained in Serbian society over the years. The only exemption from this rule is detectable in the Proposal of the Law on the NBY of 2002. An extremely high index of legal CBI (LVAU=0.90) in comparison to other transition countries' indices measured in 2000, point to the unbalanced approach toward the central bank independence. According to Dvorsky (2000, p. 80), only Poland had a higher index of legal CBI (LVAU=0.91), whereas all other 'fast reformers', that is, the Czech Republic (LVAU=0.69), Hungary (LVAU=0.78), Slovakia (LVAU=0.68) and Slovenia (LVAU=0.60) had a lower CBI index than the one proposed for the NBY in 2002.[62] As this law was never enacted, however, the results should be treated with reserve. The analysis, nonetheless, confirmed the existence of inherited central banker's propensity for greater autonomy.

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[62] It should be noted that indices are not entirely comparable as Dvorsky (2000, p. 79) applied the rationale of the Maastricht Treaty wherever national legislation did not clearly fit into any of Cukierman's (1992) category. However, this does not diminish our conclusion; on a contrary, it only strengthens it.

Returning to the above-noted conservatism, it appears in the case of Serbia that not only the actual monetary and exchange rate policy-making has been constrained by the conservative attitude, but also the central bank institutional framework has been also. Whether the two are related is not entirely clear. The heterogeneous inflation record of the 1993-2003 period suggests that they are not; relatively modest legal central bank independence was coupled both with high inflation and hyperinflation (1993-2000), and with the inflation stabilisation (2001-2003). Moreover, the period of stabilisation and exchange rate fixity continued under a more independent central bank (mid-2003 to 2005). This occurrence may be attributed to the 'historical' obligation to keep inflation at a low level, which in turn ties the hands of central bankers by constraining the prioritisation among different macroeconomic objectives at given times.[63]

This is entirely in line with economic theory, which suggests that delegation or fixed policy rules are the devices through which governments signal their adherence to sound, i.e. credible, policies (see Keefer and Stasavage, 1998). But how is it then that central bank independence matters less for economic outcomes then one would expect? Keefer and Stasavage (1998, p. 20) claim that:

> "[...] monetary delegation is only a potential solution to credibility problems when political institutions provide for multiple veto players with different preferences. [...] the combined effect of the presence of multiple veto players and monetary delegation is much stronger in countries with higher levels of polarization, and much lower in countries with significant rates of replacement of crucial government decision markers".

This analysis leads to two conclusions. First, that governments cannot automatically transpose credibility to monetary and exchange rate policy conduct *via* increased legal central bank independence. And, second, that, ultimately, monetary policy conduct depends on the degree of (de)centralisation of political power among the political players within the country. In this, the central bank laws can only establish a level playing field, whereas the rest depends on the persons appointed to perform the functions in the highest central bank policy-making bodies and those who appoint them, i.e. the MPs. Therefore, we now turn to measuring the rate of turnover of governors, which indicate the central bank's actual independence.

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[63] We assume that this prioritisation does not run against the central bank primary objective of achieving and maintaining the stability of prices.

5.3.3. Assessing the actual CBI in Serbia in period 1989-2005

Since the Cukierman (1992) study, the turnover rate of governors has been used as an approximation for actual central bank independence. Cukierman (1992), however, was not extensive. He explained that the indicator is defined as the actual average term of office of central bank governors in a given country and that the threshold turnover most likely lies between 0.20 and 0.25, which corresponds to an average tenure of four to five years. This threshold in most countries equals to the electoral cycles as it does in Serbia where the electoral cycle is set at four years. Herein, Cukierman (1992, p. 383) presupposes that above the given threshold, "a large turnover of CB [central bank, auth. remark] governors indicates a lower level of CB independence". Finally, he finds that for the LDCs, the turnover rate of governors most likely represents a solid proxy of the actual central bank independence.

We chose to use this measure for practical reasons. Cukierman (1992, p. 384) has calculated the turnover rate of central bank governors in the case of Yugoslavia for a rather long period of 39 years (1950-1989), obtaining a rate of 0.23. Dvorsky (2004, p. 69), quite recently, re-calculated this rate for the period November 2000 to October 2004 (in the case of Serbia) and obtained a rate of 0.75. We, however, feel that this enormous drop in actual independence is artificial, notwithstanding the disastrous NBY's inflation record during the 1990s. Therefore, we posed two questions; first, on the basis of what parameters this latest indicator of 0.75 was obtained and, second, what are the reasons behind such low actual NBS independence.

In relation to the first question, we believe that the reference period used by Dvorsky (2004) is not entirely appropriate for the calculation of this index. Furthermore, the explanation offered by the author does not seem to be the most accurate. Namely, Dvorsky (2004, p. 70) claims to have applied the same reasoning to Bosnia and Herzegovina, Croatia, Macedonia and Serbia, by taking "the start of operations of the newly established central bank as the starting point of the respective reference period". Although November 2000, as a chosen date for Serbia, brought significant changes to Serbian central banking as any revolutionary event would, this date has certainly not marked the beginning of the work of the "newly established" Serbian central bank.

So as to avoid a discussion about the historical evidence of the long experience of central banking in Serbia, we shall only note that a simple analogy could have been used in determining the reference dates. If, in the case of Croatia and Macedonia (both of which are former FRY republics, as is Serbia)[64], the starting date used was the date of the appointment of the first post-FRY governor, then this logic should have been applied for Serbia, too.[65] Since this was not the case, the results obtained for Serbia are not quite comparable to those calculated for other countries. Moreover, as noted by the author herself, the results are highly sensitive to changes in either the numerator (number of governors) or denominator (tenure of reference period). We, therefore, argue that the result of 0.75 for the turnover rate of governors in Serbia is misleading, in so far as it is a product of the very short selected reference period of 4 years, rather than the credible proxy of actual central bank independence. To ensure that the results are indeed as relevant as those for other countries, we chose to recalculate the index for Serbia, based on more appropriate reference periods.

Respecting Cukierman's (1992) measurement dynamic, which offered an index for the period up to 1989, we calculated the turnover rate based on reference period (A) since 1989. (More specifics can be found in Table 5.2) This first index (A) enables us to place the issue of actual NBS independence into a historical context. The second index (B) is calculated on the basis of another reference period (B) starting in July 1992, which follows the logic applied by Dvorsky (2004). This allows us to perform a cross-country analysis and to locate Serbia within the transitional milieu. Additionally, having in mind that Dvorsky (2004) suggests that no 'acting governors' are taken into account, which is a factor affecting the numerator, we applied the same rationale to the denominator by shortening the reference periods (A) and (B) for a relevant number of years and months during which the central bank of Serbia did not have a governor. By this, we obtain a turnover rate (A1) and (B1) for respective reference periods. Altogether, we believe to have obtained a more accurate measurement of actual central bank independence in Serbia over the relevant period.

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[64] Although Bosnia and Herzegovina is also included in the study, the reference period was determined by the appointment of Peter Nicholl, the first post-Dayton governor.

[65] Starting date of the reference period in the case of Croatia is January 1992 and in Macedonia December 1993. In this case, the corresponding date for Serbia would be July 1993 (see Table 5.2).

Table 5.2. *Turnover rate of governors in Serbia in period 1989-2005*

(Country) GOVERNOR	Date of appointment / Reason for appointment	Date of dismissal / Reason for dismissal	Length of term
SFR Yugoslavia	**29 November 1945**	**26 April 1992**	
Dušan Vlaković	1 June 1986	14 July 1992	6 years 1 month 14 days
	-	Constitutional change	
FR Yugoslavia	**27 April 1992**	**3 February 2003**	
Vuk Ognjanović	15 July 1992	15 July 1993	1 year
	Constitutional change	New law enactment	
Borisav Atanacković	16 July 1993	20 October 1993	3 months 4 days
	New law enactment	Incapacity	
Dragoslav Avramović	2 March 1994	15 May 1996	2 years 2 months 13 days
	-	Dismissal (political reasons)	
Dušan Vlatković	26 June 1997	27 November 2000	3 years 5 months
	-	'bulldozer revolution'	
Mlađan Dinkić	28 November 2000	3 February 2003	See below
	'bulldozer revolution'	Formality reasons (see below)	
State Union SCG	**4 February 2003**	**date**	
Mlađan Dinkić	4 February 2003	22 July 2003	2 years 8 months
	Formality reasons (see above)	New law enactment	
Kori Udovički	23 July 2003	25 February 2004	7 months
	New law enactment	Appointment irregularities	
Radovan Jelašić	26 February 2004	date	1 year 3 months 19 days
	Repeated appointment procedure	-	
REFERENCE PERIOD (A)	**17 June 1989** Date of enactment of the new NBY Law	**17 June 2005** Cut-off date for the study	**Average length of term**
	16 years		**26.33 months**
Turnover rate (A)	**0.50**		
Turnover rate (A1)*	**0.55**		
REFERENCE PERIOD (B)	**3 July 1993** Date of enactment of the new NBY Law	**17 June 2005** Cut-off date for the study	**Average length of term**
	11 years, 11 month, 14 days		**19.57 months**
Turnover rate (B)	**0.63**		
Turnover rate (B1)**	**0.66**		

Note: * Turnover rate of governors (A1) is calculated on the basis of a reference period, which excludes sub-periods when the central bank did not have a governor; this reference period is thus shorter then the reference period used to calculate the turnover rate of governors (A) and it equals to 14 years and 6 months.
** Turnover rate of governors (B1) is based on a reference period, which equals to 10 years and 6 months.

Source: National Bank of Serbia official website [www.nbs.yu]

The data obtained shows that for both reference periods the turnover rate of governors, which equals to 0.50 and 0.63 respectively, is substantially lower then the figure provided by Dvorsky (2004), i.e. 0.75. The results are, nevertheless, worrying because they are still well above the threshold level of 0.20-0.24, suggesting that the actual independence of the Serbian central bank has been rather low in both observed periods, 1989-2005 and 1993-2005. If the denominator is corrected for a number of months during which there was no governor to head the central bank in Serbia, an even gloomier picture appears. The corresponding figures are 0.55 and 0.66 for respective reference periods (A) and (B).

In comparison to the turnover rate of 0.23, which the former-Yugoslavia had in period 1950-1989, the results here illustrate a clear deterioration in actual central bank independence. However, the low turnover rate may on the other hand imply that the governors are subservient to governments, which most likely was the case for post-World War II Yugoslavia. It is also indicative that the index of 0.23 perfectly matches the established threshold of 0.20-0.24, revealing that the governors' tenures in this period (1950-1989) perfectly fit with the parliamentary electoral cycle. Taking into account the natural role of the central bank in the socialist economic setting to plainly accommodate production plans (see Chapter II), we can conclude that the Curierman index also carries information about underlining economic systems in which the central banks operate.

For those reasons, we believe that the indices of 0.50 and 0.63 are somewhat higher then they would otherwise be had there not been so many constitutional changes in the post SFR Yugoslavia. Namely, we detect a pattern by which every constitutional change is followed by the adoption of the new central bank law and consequently by the appointment of a new governor. Out of eight[66] governors in the period 1989-2005, at least five of them were appointed or dismissed due to the constitutional (institutional) changes (Vlatković, Ognjanović, Atanacković, Dinkić, Udovički). One can, however, argue also that Jelašić, who came to replace Udovički after the repeated appointment procedure which followed the adoption of the new law, should also be included.

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[66] The calculation included governor Mladjan Dinkic only once, although formally he was governor of the NBY at the time of the FR Yugoslavia and governor of the NBY at the time of the State Union of Serbia and Montenegro, because his mandate was *de facto* uninterrupted despite formal change taking place.

It cannot be excluded that those laws would have been adopted even in the absence of constitutional alterations, but the fact remains that the adoption of a new central bank law has been the safest way for the politicians in Serbia (Yugoslavia) to release a governor from duty. The picture somewhat changes with respect to the other, shorter reference period (1993-2005) where one can notice that out of seven, three governors were either appointed or dismissed for non-institutional reasons (Atanacković, Avramović, Dinkić). In particular, Atanacković left due to poor health, whereas Dinkić came to serve his term following the revolution, which in itself was a big social and political event. Only Avramović was released from duty on purely political grounds, as he opposed to obey to requests of the ruling political *garnitura*.[67] Additionally, it appears that also the 'formal irregularities' on the basis of which governor Udovički was dismissed are questionable (see Llorente, 2004), implying that the political reasons may have stood behind her short mandate.

Whatever the reasons for the high turnover rate of governors, the fact remains that the index measuring actual central bank independence in Serbia is very low in comparison to transitional experiences elsewhere. In particular, Dvorsky (2004, p. 69) finds that corresponding turnover rate is only 0.07 in Romania, 0.14 in Bosnia and Herzegovina, 0.27 in Macedonia, 0.29 in Bulgaria, and 0.31 in Croatia. Only Albania has a turnover rate which is similar to that of Serbia (0.50). However, if reference period (B) is considered (1993-2005), even this departures from the NBS index (0.63) substantially.

To conclude, we point to the evidence collected throughout our study signifying that even in an environment of moderate (limited) central bank independence, as existed in Serbia in period 2001-2005, the central bank may achieve good (inflation stabilisation) results. This, in a way, contradicts Cukierman *et al.* (2000, p. 1) who claim that "legal CBI, no matter how high, **cannot** contain the powerful inflationary impact of wide scale liberalisation of formerly controlled prices". The first, preliminary assessment of Serbia's stabilisation performance indicates that, in fact, even a moderate CBI *can* restrain the initial inflationary impact of transition. This, however, does not necessarily mean that either legal or actual CBI is the only determinant of inflation stabilisation.

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[67] See Dinkić (2000, pp. 286-292)

5.3.4. Concluding remarks

When discussing central bank's independence, it is important to understand its true meaning first. In Serbia, this basic postulate has often been neglected and so independence has often been confused with accountability. Independence does not provide the central bank's governing bodies with the autonomy to act disjointedly from other institutions within the system. It does assume, however, that central bankers have the authority to implement policies designed for achieving its primary objective, that of price stability, which unequivocally should be proscribed by a central bank law.

It appears from our analysis that this lesson had not been fully embraced and that only in 2003, with the adoption of the new National Bank of Serbia Law, has the focus on the stability of prices sharpened. To be able, however, to achieve this objective, the NBS should also be given full personal and financial independence. Our analysis has illuminated parts of the NBS institutional framework, which need to be additionally strengthened. A good guide in this could be found in the provisions set by the European Monetary Union, but also in the tradition of cooperation among various institutions, such as exist in the European Union. The comprehensive overview of the genesis of central bank legal reform in Serbia over the last 15 years also points to the necessity of adequately positioning the NBS within the broader constitutional framework, so as to reduce (preclude) any contingencies relating to its status and its role.

Together, those qualities should enable the NBS to gain more *legal* independence, which currently hovers around the average for transitional economies. The evidence on the *actual* NBS independence is, however, the most worrying as it is substantially lower than the SEE average. Governors in Serbia hold their office only slightly longer then one year and a half. It is thus understandable that it is less likely that a long-term anti-inflation policy can be pursued. As a consequence, we found that the personal credibility of governors was one of the key factors in several stabilisation episodes. The institutional credibility of the NBS can only be repaired if actual NBS independence is increased (allowing governors to concentrate on pursuing long-term counter-inflation monetary policy) *and* if the NBS actively engages in raising public awareness about monetary policy issues. The next section sketches some reflections about the aformentioned issues.

5.4. Prospects for Serbia: Increased Central Bank Credibility

Central bank autonomy, as explained in Chapter II, does not mean that all short-term disturbances in an economy should be disregarded along with all short-term economic developments. Goodhart (1993) argues that it is the level of the central bank credibility that determines the capacity of monetary policy to accommodate the short-term shocks. It follows that the more credible and independent central bank with a longer record of low inflation has a higher capacity to act as a shock absorber in the short run. It is also important to recall that the central bank's credibility can only be obtained if there exists a wide political consensus supporting the long-term counter-inflationary monetary policy and general public's understanding of monetary policy issues. We claimed earlier that the NBS lacks genuine credibility. This view is supported by Serbia's poor inflation record over the last 15 years (Chapter III) as well as by the data we have obtained pointing to the NBS's modest level of legal and actual independence (see Section 5.3). Therefore, the question arises as how can this credibility be restored and what are the necessary steps which need to be taken?

The purpose of this section is to draw attention to several possible policy actions.[68] The focus shall be on Serbia, but we nevertheless hope that some of those recommendations will be instructive to some other Western Balkan countries. As constitutional considerations have played a great role in the modern Serbian central banking history (1989-2005), during which period the NBS practically lost its credibility, we will look into the prospects of the new Serbian constitution first. In addition, being aware of the fact that each constitutional change in Serbia so far has led to the establishment of a new central bank framework, we will try to highlight the aspects of the current NBS law which requires improvement. Having in mind that the alterations in the NBS legislation will be taking place in the context of EU membership, we will use EMU requirements as a yardstick in this analysis and will build on what was said already in Chapter IV. Finally, the section will conclude with some practical suggestions about how to increase the NBS's accountability and transparency and, ultimately, its credibility.

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[68] Herein, we shall apply a deductive methodology, starting from more general and conclude with some specific issues.

5.4.1. The new Serbian constitution

The public and political debate about the new Serbian Constitution begun in earnest after the October 2000 democratic changes. The consensus about the final content and the wording of the new Constitution has not been found yet, despite the fact that the current Constitution has been perceived as "the most serious institutional obstacle for a full democratic transformation of Serbia" (Government of the Republic of Serbia, 2004, p. 34). However, until this consensus is found, the Republic of Serbia, i.e. its institutions, shall continue operating on the principles laid down in the September 1990 Constitution of the Republic of Serbia[69]. The current Constitution was adopted at the time of existence of the FR Yugoslavia, when Serbia was one of its federal units.[70]

The current Constitution contains very reserved provisions relating to the Serbian central bank. As explained already, only two articles regulate the status of the central bank and its Governor: Article 107 proclaims that the Republic of Serbia has the National Bank and stipulates that the status, organisation, management and conduct of the National Bank are regulated by the law, whereas Article 73 prescribes that the Serbian parliament is to appoint and dismiss the governor of the National Bank. Clearly, such modest provisioning does not guarantee the institutional stability of the National Bank of Serbia and it thus needs to be rewritten. How this is to be done is our main question here. We shall restrain our analysis on the official government version of the Draft Constitution of the Republic of Serbia (thereafter: Draft Constitution)[71], which it submitted to the parliament at the beginning of June 2004, and on the proposal[72] made by Djordje Djukić, the leading Serbian central banking expert (see Box 5.1).

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[69] Official Gazette of the RS, No. 1/90.

[70] In February 2003, the FRY ceased to exist and Serbia became a member state of the State Union of Serbia and Montenegro. By adopting the Constitutional Charter of the State Union Serbia and Montenegro, the Republic of Serbia undertook the obligation to align its Constitution with the Constitutional Charter within the six-month period. This deadline expired in August 2004. See Article 65 of the Constitutional Charter and Article 20(2) of the Constitutional Charter Implementing Law.

[71] Government text of the new Constitution is based on the parliament's Decision on Proceedings to the Adoption of the New Constitution of the Republic of Serbia, Official Gazette of the RS, No. 35/04. Accessible at the official website of the Government of the Republic of Serbia [www.srbija.sr.gov.yu]

[72] As published in the article 'Strengthening the Independence' [*Jačanje nezavisnosti*] published by the magazine *Ekonomist*, No. 263, 6 June 2005, pp. 15 and 16.

Box 5.1. *Draft constitutional provisions regulating status of the National Bank of Serbia*

Extract from Draft Constitution prepared by the Serbian Government (June 2004)

National Bank of Serbia

Article 93

The National Bank of Serbia is the central bank of the Republic of Serbia, which is autonomous and subordinated to the supervision of the National Parliament to which is responsible.

The National Bank of Serbia is managed by the governor, who is appointed by the National Parliament for a six-year term at the proposal of the President of the Republic.

A law is to be adopted on the National Bank of Serbia.

Article 95 (4)

The National Parliament [...] appoints and dismisses the National Bank of Serbia's governor [...].

Article 102 (2)

By majority vote the National Parliament [...] appoints and dismisses the National Bank of Serbia's governor [...]

Article 104 (2)

The Ombudsman and the National Bank of Serbia have the right to propose laws within its field of competencies.

Draft Constitution provisions regulating status of the National Bank of Serbia prepared by Djordje Djukić

The National Bank of Serbia is the central bank of the Republic of Serbia, which is independent in its work and responsible for the value of the domestic currency.

The governing body of the National Band of Serbia is the Monetary Council composed of the president and six members. The President and the members of the Monetary Council are appointed by the National Parliament for a six-year term at the proposal of the President of the Republic.

For its work the National Bank of Serbia is responsible to the National Parliament.

Status, responsibilities and other particularities, which relate to the National Bank of Serbia are regulated by law.

Governing principles in drafting of the new Serbian Constitution (author's proposal)

- To institute the NBS as an autonomous legal entity;
- To confer the NBS independence in formulation and implementation of policies aimed at the fulfilment of its primary objective, which is to be unequivocally stipulated by the NBS law (i.e. achievement and maintenance of the price stability);
- To institute a collective decision-making body as the highest governing organ of the NBS, which is to be accountable to the National Parliament;
- To ensure that the governor is appointed by the National Parliament, at the proposal of the President of the Republic, for a term of at least five years;
- To ensure that the governor is dismissed by the National Parliament only if he no longer fulfils the conditions required for the performance of his duties or if he has been found guilty of crime;
- To secure that the NBS governor presents to the National Parliament a report on the activities and results of the NBS at least once annually;
- To ensure that the status and organisation of the NBS are regulated by an NBS law;
- To give the NBS the constitutional right to propose laws within its field of competencies.

Source: Government of the Republic of Serbia (2004, pp. 16 and 18); *Ekonomist*, No. 263, p. 15.

What is striking about the Government's proposal is that it contains a 'systemic error' by instituting a single-person decision-making body as the highest NBS organ (Article 93(2)). We have seen from our earlier analysis of the FRY Constitution and earlier NBY laws that such a solution carries with it many potential costs for the society. In respect to that, the second proposal seems more appealing as it presupposes the existence of a collective decision-making body in line with international and European practice. The explanation offered by Djukić (2005) is that the specification of the number of the Monetary Council members in the new Constitution would eliminate the possibility for any future ruling coalition to manipulate the monetary authority by changing the number of Council members according to their own interests by simply adopting a new NBS Law. We, however, find this observation too rigorous and argue that the composition of the NBS governing body should be regulated by the NBS Law and not by the Constitution, so as to leave enough flexibility for the legislature to propose the most adequate model of NBS organisation. After all, the parliament is composed of democratically elected representatives of political parties, who won their votes on the basis of their legitimate policy programmes – the implementation of which may, at times, require changes in the institutional organisation of the National Bank of Serbia (including a change in the number of the NBS's governing body).

Interestingly, an analysis of the two drafts reveals another confusion, which arises from the concept of central bank independence. Namely, the government's Draft Constitution envisages that the NBS is "*samostalna*", which translates as "autonomous". Some authors indeed use the terms 'autonomous' and 'independent' as synonyms (see Goodhart, 1993). But, a distinction should be made. In legislative terms, autonomy implies the institutional freedom of the central bank to function as a separate institution within an overall system as a separate legal entity. In economic terms, as explained already, the central bank's independence entails the liberty of the central bank to define and implement the policies needed for achieving its primary objective. We note that each draft refers only to one concept; the first to 'autonomy', and the second to 'independence'. We thus propose that the new Serbian Constitution include both notions so as to ensure the constitutional independence of the National Bank of Serbia, but also its constitutional right to be established as an autonomous legal entity.

Also very important is that the new Constitution recognise the NBS as independent in terms of the formulation and implementation of its primary objective. It is equally surprising that the government's Draft Constitution remains silent about this issue, and that the second proposal contains a reference to the NBS's accountability regarding the "value of the domestic currency" (paragraph 1). If anything is clear from the economic literature on the functioning of a market economy to which Serbia is adhering, is that the market sets the value of goods and services as well as the value of the national currency. It is, therefore, of the outmost importance for all those who engage in the drafting of the new Serbian Constitution or the new NBS Law to apply the difference between the concepts of the 'currency value' and 'price stability'.

We also point to the necessity of distinguishing between the NBS's accountability for achieving its primary objective (which may as well be the stability of prices) and the NBS's independence to define and implement its primary objective. Whereas we find it appropriate for the new Serbian Constitution to include a provision on the former (formulation and implementation of monetary policy), we believe that the later (primary objective) should be defined by the NBS Law. Presumably, the achievement and maintenance of the stability of prices will remain the primary objective of the NBS in future times, especially having in mind the prospective of EU membership[73]. However, one cannot exclude the theoretical possibility that, for example, the reduction in unemployment or maintenance of financial stability, be chosen as the primary objective in line with the preferred policy outcomes at a given future period.

Also ambiguous is the end-wording of Article 93(1) of the Draft Constitution which in Serbian reads "*kojoj i odgovara*", which literally translates as "to which it responds". We suppose that the government had in mind the following meaning when proposing such article: "*kojoj je odgovorna*", that is, "to which it is accountable". If this were the case, the wording should be adjusted to the intended meaning so as to preclude any misinterpretations. Similarly, the Djukić proposal (paragraph 3) stipulates that the NBS for its work "*odgovara*", i.e. "responds" to the National Parliament. If clarity is to be secured, then the proposal should read "*je odgovorna*", that is, "is accountable".

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[73] See Article 105(1) of the Treaty and Article 2 of the ESCB Statute.

More substantially, we point to the necessity of coupling the (rightly) envisaged NBS accountability towards the National Parliament with the obligation for the Governor to present to the parliament an annual report on the NBS's activities and results.[74] Not only would such an approach exemplify the modality by which the aforementioned accountability would be achieved, but it would additionally increase the NBS's independence in relation to other branches of government. Namely, by having the opportunity to address the parliament, the Governor is given the right to explain what factors have influenced the conduct of monetary policy over which the NBS does not have authority. In this way, the NBS would only be held accountable for the achievement of its primary objective up to the point in which the achievement of that objective depends on factors that the NBS can control. This is in line with the economic theory saying that the achievement of a central bank objective is also determined by factors outside the scope of monetary policy (for example, large budget deficits).

Finally, we note that both draft versions propose that the term of office of the highest NBS governing body be set at six years.[75] This solution is entirely in line with European practice, by which the governors of the national central banks of the EMU Member States should be assigned mandates of at least five years.[76] It is, in any case, important to ensure that the governor's office term exceeds the regular, four-year electoral cycle. In order to secure the personal independence of the governor, the new Serbian Constitution may include, in addition, a provision relating to the governor's dismissal procedure, which should be based exclusively on non-policy reasons, such as is the case in the European Union.[77]

The analysis makes us conclude that there are a number of considerations which need to be taken into account if one wishes to avoid systemic errors from the past and to embrace high contemporary European standards. Instead of engaging in the drafting of the actual constitutional provisions, which would only be relevant for Serbia, we have proposed a set of guiding principles that have a more general character (see Box 5.1)

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[74] The similar solution exist in the Hungarian Constitution (Article 32D(3)).
[75] The proposals envisage that the governor is appointed at the proposal of the President of the Republic of Serbia. This is a welcomed and common solution that ensures checks and balances between the different government branches and limits government's appointment powers (see Dvorsky, 2004).
[76] See Article 14(2) of the ESCB Statute.
[77] *Ibid.*

5.4.2. New Law on the NBS: Fulfilling the E(M)U requirements

It was during Summer 2003, when the NBS law was in preparation, that Serbia had an excellent chance to increase the public's awareness about the relevance of the NBS's independence and about the causality that exists between this independence and the central bank's results. Due to a fierce political debate that surrounded the drafting, adoption and implementation of the NBS law enacted in mid-July same year, this opportunity was wasted. The substance of the law and the constructive discussions were over-shadowed by the political disputes between the NBS governor, the Prime Minister and the Finance Minister. One would expect that – although the public awareness has not been increased – at least the political elite would have understood the significance of these issues. Our previous analysis of the Draft Serbian Constitution discloses that this is, unfortunately, not so. More worrying, however, is that not much of an academic discussion (if any) has taken place or been initiated about the current institutional status of the NBS and the particular features embodied in the current NBS Law since its instauration. Our intention here is to initiate that debate and to de-couple it from political interference. The analysis will build on what was already said about the NBS law, but will be deepened so as to disclose the provisions that need to be further aligned with the EMU's requirements in view of the prospective EU membership. A similar study has already been done by Dvorsky (2004), who analysed the independence of central banks in SEE countries in view of their future EU accession. We shall lean on this work but will, nevertheless, try to be more specific, focusing only on Serbia. Our contribution will also include some reflections on Cukierman's (1992) formulation of central bank independence, which in some areas is stricter than the EMU-related *acquis*.

According to Article 105(1) of the Treaty and Article 2 of the ESCB Statute, the primary objective of the ESCB is to maintain price stability, while the secondary objective is to support the general economic policies of the European Community, without prejudice to the objective of price stability. According to Dvorsky (2004), who bases his view on the ECB's convergence report, the statutes of the national central banks of the new EU Member States should have price stability as their primary objective from the date of their EU accession.

Dvorsky (2004, p. 55) also claims that the NBS law will require adaptation, as the objective of the "maintenance of financial stability" may be seen as being in tension with price stability. Although we believe that the primacy of the price stability objective is ensured by the actual wording of the current NBS law (see Section 5.3.1), it is likely that Article 3(2) of the NBS law will need to be rewritten so as to unambiguously reflect the letter of the Treaty. Instructive in this respect may be Article 4 of the Bank of Slovenia Act[78], adopted in July 2002 in the course of alignment with the EMU *acquis*.

In order to further strengthen the NBS's institutional independence and to ensure full compatibility with Article 108 of the Treaty and Article 7 of the ESCB Statute, Article 2(3) of the current NBS law will possibly need to be extended so as to include other external forms of influence (other's points of view, instructions, decisions, etc.) At this juncture, the afore mentioned article of the NBS law refers only to 'instructions'. Besides, the new drafting will have to prescribe the same obligations for each individual member of the NBS decision-making body. Regarding the NBS's independence to formulate and implement policy, we find that this is secured by Article 4(1) of the NBS Law, including the determination of the exchange rate regime upon the government's consent (Article 4(2)). Our conclusion is based on provisions contained in Article 111(1) of the Treaty which as well require close ECB involvement in the formulation of the exchange rate regime, but also on Article 105(2) of the Treaty and Article 3(1) of the ESCB Statute relating only to the ECB's obligation to "conduct foreign exchange operations consistent with the provisions of Article 111".[79]

It should be noted that part of personal independence derives from limits to the government's influence in nominating the members of the NBS's policy-making bodies. The current solution, by which the Governor is nominated by the Parliamentary Committee for Financial Affairs is not unique, although some authors imply that it is.[80] Nevertheless, we support the idea that the President of Serbia be given a constitutional right to propose the NBS governor, upon adoption of the new Serbian Constitution.

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[78] Official Gazette of the Republic of Slovenia, No. 58/02. See also Article 3(3) of the ESCB Statute.

[79] See also Goodhart (1993, p. 7) who claims: "Despite awarding an unusual degree of independence to the ESCB, the framers of the Maastricht Treaty kept exchange rate decisions in the hands of the politicians".

[80] Đukić (*Ekonomist*, No. 623, p. 16) refers to the "solutions, which the world does not recognise". However, according to Dvorsky (2004, p. 58), the laws on the central banks of Bulgaria, Croatia, Macedonia and Romania also have similar provisions.

Although neither the Treaty nor the ESCB Statute contain provisions on the appointment of officials of the national central banks, they do regulate the dismissal conditions for national central bank governors (Article 14(2) of the ESCB Statute), stipulating that "a governor may be released from office only if he no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct". Dvorsky (2004) argues that none of the SEE central bank laws is compatible with those provisions. We, however, point that the relevant provisions contained in Article 30 of the NBS law are compatible in principle with the EMU requirements, but that they may need some fine-tuning.

A propos the governor's term of office, which is by Article 14(2) of the ESCB Statute set at 5 years for the national central banks' governors, we find that NBS law (Article 16) is fully EMU compatible. Although Dvrosky (2004) claims that a renewal of governor's mandate is not welcomed, as neither the Treaty nor the ESCB Statute include any provisions relating to the reappointed of the national central bank's governors. Thus, a renewal provision is assumed to be compatible with the EMU *acquis*. Nevertheless, full NBS independence with respect to this would only be achieved if the governor were prohibited from holding another mandate (see Cukierman, 1992). Regarding the incompatibility clauses, these would need to be modified so as to reflect the provisioning of Article 11(1) of the ESCB Statute requiring the ECB Executive Board members not to engage in any occupation that creates conflict of interest.

In relation to budgetary independence, we may say that the NBS is independent as the NBS Council adopts the NBS financial plan at the Governor's proposal (Article 24(1) of the NBS Law), without prior government approval. However, in relation to financial lending to the government, major modification will be needed; in particular, Art. 36, 39 and 77(4,5,6) of the NBS law, which are incompatible with Art. 101(1) and 102(1) of the Treaty and Article 21(1) of the ESCB Statute. In order to align the NBS law with these provisions, the legislature will have to adopt solutions by which any form of lending to the government (securitised or non-securitised), will have to be *explicitly forbidden*. Also, the allocation of net NBS revenues and the coverage of NBS losses *via* the issuance of interest-bearing government papers would need to be prohibited, too. In this, it should be noted that the Treaty does not contain provision of indirect central bank credit either.

5.4.3. A case for a transparency hike and increased NBS accountability

Creating a new legislative framework is a first decisive step in central bank reform. The next, consecutive move relates to the practical implementation of the newly established rules. These two reform actions have drawn much attention in the literature on the economics of transition, but scholars seem to be less drawn to an equally important aspect of central bank reform – improving the central bank's image. In the words of Hilbers (1993, p. 20): "The central bank not only has to abandon old activities and gain experience in new ones, but also has to change its image". We believe that the concept of transparency, as given by Winkler (2000), can be used in the case of Serbia to improve the image of the National Bank of Serbia. It should be noted, though, that the notion of transparency in monetary policymaking entered the sphere of academic discourse only recently and that existing studies do not focus on the issue of transparency in transition economies. On the contrary, having in mind that a consensus about the desirability of transparency in monetary policy matters has not yet been reached (see Geraats, 2002), the literature is still restricted to general arguments about various aspects of central bank transparency, motives that derive from these aspects, and to measurement problems (see Chapter II).

We, however, believe that these deliberations should also consider a specific dimension of transparency, typical for transition economies. Namely, while Posen (2002) assumes that there exists trust and goodwill in the ongoing relationship between a central bank and its general public (including financial markets), we claim that this is not the case in the transition economies. Whereas in developed economies there are no fundamental misunderstandings about a central bank's commitment to low inflation (see Posen, 2002), this situation does not reflect the actual state of affairs in transitional economies, including that of Serbia. Therefore, we argue that the assumption of the existence of such a frank relationship between the central bank and the general public in transition economies cannot be made, as the central bank priorities in transition change (see below). Consequently, the central bank's transparency in transition should include another, rather elementary aspect of transparency: raising the public's awareness about what monetary policy can and cannot do in general.

One can argue that if a relationship between the central bank and the general public about the central bank commitment to low inflation does not exist, the opposite can be assumed, i.e. that a central bank has a strong inflation bias and that it is 'soft on inflation'. This indeed may be so, but we are pointing to the fact that, by definition, the transition process is about *changing* policy preferences and attitudes, including a central bank's responsiveness to inflation. As a result, two questions appear relevant: (1) how quickly a central bank in transition changes its policy preferences, and (2) how (quickly) the general public is learning about those changes. In relation to the first question, we tend to believe – based on the realisation of stabilisation results in transition countries (including Serbia) – that the central bank improves relatively fast, although the issue about the actual degree of a central bank's 'dryness' *vis-à-vis* inflation remains.

With regards to the second question, the following consideration is relevant. Chapter IV disclosed that the general public in Serbia perceives the monetary policy largely non-credible (e.g. high euroisation), thereby tying the hands of the NBS in view of short-term economic disturbances. In order for the general public to be able to grasp the central bank's changing policy preferences from 'soft' to 'hard', an active engagement of the NBS's officials in developing their 'presentation skills' (see Goodhart, 1993) is imperative. Existing central bank transparency conceptual frameworks (see, for example, Winkler, 2000; Geraats, 2002; Posen 2002) should be used as a starting point in this exercise. Herein, we propose that a broader definition of transparency – "as a measure of genuine understanding and successful communication" (Winkler, 2000, p. 26) – be used instead of its narrow definition.[81] In other words, we believe that the focus should be on several practical dimensions of transparency: openness, clarity, common understanding and honesty. In fact, we argue that the central bank's aggressive engagement in the presentation of the monetary policy issues based on these postulates may greatly increase its accountability and the overall general public's perceptions about the changes taking place in the monetary sphere. This is not to say, however, that a long-term counter-inflationary policy could be replaced by those measures, but that these may adequately supplement it.

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[81] Winkler (2000, p. 26) notes that "the academic literature on transparency in monetary policy making has, of course, given precision to the term "transparency", which is defined narrowly with the release of information or the inverse of noise and uncertainty within a particular class of models".

In practical terms, a number of solutions can be applied. For example, we already proposed that the new Serbian Constitution include a provision on the NBS governor's obligation (and his right) to personally present the NBS's annual report to parliament once a year. If one is to classify such activity, it would have to be treated as a measure relating to the central bank's accountability because of its *ex post* character.[82] However, we argue that a presentation of the central bank's annual report to parliament by a governor personally also includes important elements of a central bank's transparency. Namely, if, as is the case now, the NBS merely submits its annual report to parliament, the parliament may or may not choose to debate it. Even if the MPs (i.e. members of the Parliamentary Committee for Financial Affairs) do decide to scrutinise the report, this activity will not be transparent and the public will not be given the opportunity to join in the debate.

Therefore, given Serbia's weak parliamentary practices, it is important that such activity be institutionalised, as this will boost both the NBS's accountability and transparency. Having in mind that parliamentary sessions are broadcasted live on the Serbian National Television, the practical implications of this measure are: (1) NBS governor will be given the opportunity to address the parliament and explain all factors that influenced the achievement of the NBS's primary objective, (2) MPs will be given a chance to ask questions and engage in a learning process, (3) the general public will be involved in this learning process, too, and consequently, (4) the transparency and accountability of the NBS will increase. Ultimately, this simple exercise may help the NBS increase its credibility, under the assumption that this 'public reporting' is accompanied by a low-inflation record. We also believe that this is one way by which the credibility of the NBS can be institutionalised – in contrast to the actual situation in which the NBS's credibility depends primarily on the personal credibility of its governor. This is, however, not to say that society can hedge against the possible misuses of a central bank exclusively on the basis of a legal central bank framework. On the contrary, society also has to engage actively in selecting the candidates for the highest central bank positions by insisting on their personal and professional credibility and reputation.

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[82] Castellani (2002) argues that in contrast to accountability, which is seen as *ex post* political scrutiny of central bank's deeds, the central bank transparency represents a set of *ex ante* decisions about the central bank communication and presentation actions.

5.4.4. Concluding remarks

This analysis unveils one alarming fact: that Serbia's political elite is ignorant of the far-reaching, negative consequences of a constitutional solution by which the National Bank is headed by a single person – the governor. Such ignorance may emanate from two different sources: lack of knowledge or a detrimental political deliberation. Whatever the case, it is our duty to point to the fact that in the context of a single-person NBS governing body, none of the central bank's concepts (independence, transparency, accountability and credibility) can be fully realised. As a result, Serbia may continue lagging behind the prominent reformer countries in terms of central bank reform (and other reforms), as was the case during the 1990s.

In an attempt to prevent that from happening, we have singled out the main guiding principles which are to be followed in drafting the new Serbian Constitution. These include the necessity to establish the NBS as an autonomous legal entity, independent in formulating and implementing its policies aimed at achieving its primary objective (presumably price stability) with a collective policymaking organ as the highest NBS body whose members would be accountable to the National Parliament. Furthermore, in order to secure the NBS governor's personal independence, we suggested that the governor be appointed by the Parliament after being nominated by the President of the Republic, for a term of at least five years, and that he be dismissed the non-policy reason only. Under the assumption that these principles will be respected and that Serbia will in the foreseeable future be faced with the more complex task of aligning its central bank legislation with that of the EU, we also examined specific provisions of the current NBS legislation that requires modifications. These appear to be few, although critical.

Lastly, we concluded that the NBS may benefit from a systematic engagement in pedagogical activities, trying to explain to the general public its new role in a changing, transitional environment. By increasing its transparency *via* a simple annual presentation of the NBS's activities to parliament in person, we found that the NBS governor may contribute to a better understanding of monetary policy issues. Consequently, it appears that the NBS will also strengthen its accountability towards general public and will ultimately, although gradually, restore its credibility.

5.5. Conclusion

Nominally, the transition in Serbia (i.e. Yugoslavia) began with central bank reform, as suggested by the economic theory (see Bruno, 1993). The analysis of the NBY Law of 1989 conducted here, however, discloses that this law did not bring any substantial increase in the central bank's independence and that the introduced changes were more cosmetic then real. The reasons behind this occurrence were purely political. This was a time with a high incidence of political pressures stemming from the republics which sensed the dissolution of the country and thus refused to delegate more power to federal institutions and their delegates, including the NBY. This finding is fully in line with our earlier conclusion reached in Chapter III that political consensus is a prerequisite for any successful transition, and that it extends to central bank reform in particular.

The second wave of central bank reform in Serbia took place in 1993. It was, however, more a result of a delayed institutional defining of a newly-formed country (the FRY) and an opportunity to replace an inadequate cadre[83], than a serious attempt to establish a solid institutional central bank framework and to fight hyperinflation. It appears, nevertheless, from the evidence we provided, that the measured *legal* NBY independence during this period was twice higher than that assigned by the NBY law of 1989, although it was still rather moderate in comparison with other countries. Having in mind a devastating, long record of high inflation during the most of the period of this law implementation, we conclude that (moderate) legal central bank independence may not necessarily be conducive to low inflation. On the other hand, the period of successful inflation stabilisation that followed the political changes in October 2000 indicates that moderate legal central bank independence may be sufficient for the central bank to contain inflation. The analysis of these two laws illuminates the sombre fact that *legal* central bank independence, at least if it is below a certain threshold, appears ineffective in slowing inflation on its own. The political and personal motives of governors and politicians that appoint them seem to weight considerably more.

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[83] Vuk Ognjanović, a Montenegrin residing in Serbia, was the NBY governor from 15 July 1992 to 15 July 1993. Formally, he was dismissed from the position of the NBY governor because of the adoption of the new NBY Law, but we found out while conducting interviews that he was, in fact, dismissed so as to be replaced by the Serbian cadre.

As legal independence matters little (if anything), whereas the personal behaviour of a central bank governor is decisive to the overall central bank conduct, it follows that it is impermissible to only institute a governor as the sole policymaking organ of a central bank. We believe that this is so even in the case of the appointment of a conservative central banker. Namely, one could think of numerous ways in which the political elite may apply pressure on governor under the circumstances in which he appears to be the only decision-maker. The opposite may be conceived as well, since a central bank governor may equally successfully manipulate a government. That the potentials for a conflict are real is proven by Serbia's experience in 2003. One interesting line for further research would be to investigate the effects of those conflicts on the conduct of monetary policy and exchange rate movements (if any), or to search for the optimal balance between central bank independence and accountability in circumstances in which a governor is the only source of policy formulation and implementation. In any case, this finding further stresses the need to constitutionally establish a collective decision-making body as the highest central bank governing body.

The evidence presented also reveals that, despite a common belief that the NBS Law of 2003 reduced the central bank's independence, the NBS was provided with more independence than ever before. We also found that the degree of current *legal* CBI is in line with the rest of transition countries, suggesting that Serbia is currently on the right track, even though it experienced a substantial initial delay of about a decade. Our analysis also demonstrates that many provisions of the current NBS law are in line with the highest European standards, but that equally, there exist a number of provisions which will require further harmonisation with the EMU *acquis*. (These provisions that would need intervention prior to EU membership are listed in Section 5.4.2).

Certainly, more alarming is the result that we obtained in relation to *real* NBS independence, as this result appears to be well below the regional average. Dvorsky, however, (2004, p. 92) finds that "the results on turnover rate of governors do not truly reflect the degree of actual CBI". Does this mean that no reactions to these poor results should take place in Serbia? Although we agree that the index should be taken with reserve, we believe that the NBS, as well as the other branches of government in Serbia, should consider the issue of how to improve the actual CBI with great seriousness.

Our initial reflections made us nominate the concept of transparency in the presentation of the NBS's monetary policy strategy and in other tasks as a possible solution to this problem. However, as explained already, we do not necessarily imply that the NBS should increase transparency in monetary policy conduct per se, as there is no enough evidence on its conduciveness to monetary policymaking (see Geraats, 2002). The NBS, nevertheless, may wish to do it anyway. We believe that greater engagement of the NBS' high officials in educational activities focusing on explaining what monetary policy can and cannot do in general – both to the general public and to the political actors – may contribute to strengthening the NBS's reputation and credibility. A useful guide in this exercise may be the practice developed by the ECB, whose credibility the NBS would hopefully, eventually, be in a position to import. Initially, this process will occur gradually *via* the adoption of the EMU *acquis*, and later on considerably faster, as Serbia joins the EU as a full-fledged member.

Chapter VI Summary and Concluding Remarks

"The rule of law is preferable to any individual"

Aristotle

This work was inspired by the vast literature on the economics of transition and our great personal interest in institutional and operational central banking issues. The greatest challenge of this research was to join these two arcs of inspiration together, answering the question of the role of central bank reform in the transition from a socialist to a market economy. An additional complexity derived from the fact that a central bank is an institution that itself must be transformed during this same transition. The literature review, presented in Chapter II, reveals that the answer to our question depends primarily on the inherited macroeconomic conditions of the ex-socialist economies and the passive role that money and credit had in the central-planning environment. As a consequence, the transition had to start with the sharp macroeconomic stabilisation of macroeconomic variables, which imbalances derived from repressed inflation and unsustainable fiscal and external deficits. This was so because these two were seen as the main sources of the excess demand of socialist economies.

The transition began with a liberalisation of administered prices and trade, producing a large monetary overhang resulting from a sudden rise in the measured average price level. Both theory and practice has shown that countries that applied exchange-rate based stabilisation programmes – with the exchange rate as a nominal anchor – were more successful in bringing down inflation even when faced with immense fiscal deficits and sluggish structural reform processes. It follows from this that the central bank had a great role in the early years of transition, being responsible for inflation stabilisation and the design of a new monetary strategy by which stabilisation was to be achieved. We were interested to see whether Serbia followed the same pattern and whether there were any particularities in relation to the role of the National Bank of Serbia in this process, having in mind the country's complex constitutional and political background.

Chapter III revealed that Serbia, as a part of larger country, i.e. the Socialist Federal Republic of Yugoslavia, was the first country in Eastern Europe to start the transition. A comprehensive anti-inflationary programme launched on 18 December 1989, two weeks before the widely debated Polish stabilisation programme, was proposed by the President of the SFRY Federal Executive Council, a reformist Croat Ante Marković, by whom this programme will be remembered. Nominally, the reform plan included the components of what later became known as the "transition blueprint", i.e. a wide set of measures designed to address the following issues: inflation stabilisation, fiscal and financial system consolidation, price and import liberalisation, the establishment of a new business environment, the privatisation of state- and socially-owned enterprises, the regulation of new labour relations, the establishment of a social safety-net, etc. Seemingly, the SFRY had every chance to become a prominent reformer.

The stabilisation programme, however, was to be implemented in a situation of inherited severe macroeconomic imbalances resulting from the years of socialist mismanagement. We recall that, the SFRY had been using since the beginning of 1950s its own type of "market socialism" and that it had failed to secure sustainable growth and macroeconomic stability of the economy. After an initial post-World War II period of central planning, followed by fifteen years of self-management and economic growth that lasted until 1965, and subsequent marked-oriented reforms, the country fell into an economic crisis in the early 1980s. The beginning of this period was marked by the country's recognition that it could no longer finance its debt obligation. Although the external position was stabilised relatively quickly, the economy recorded low levels of investment, which at first turned into stagnation and later on into an overall decrease in economic activity and growth. By the end of the 1980s, the quasi-fiscal deficit that existed among various enterprises had mounted, and were monetised largely through excessive wage demand, thereby fuelling inflation. In such circumstances, the exchange rate and credit risks were born by the National Bank of Yugoslavia, which acted as the lender of last resort. Consequently, the annual inflation rate registered in 1989 reached 1,256 per cent, entering a state of hyperinflation.

The crux of the problem was, nevertheless, political. An increase in nationalist feelings and a corresponding unwillingness of the federal units (republics and autonomous provinces) to participate in the re-distribution of political power back toward the federal state led to disagreements and, eventually, to the dissolution of the country in 1991. Our analysis revealed that a lack of political consensus was the main stumbling bloc for a successful implementation of the 1989 transition package. This was reflected also in the central bank legislation of 1989, which conferred a symbolically higher independence to the NBY in comparison to the previous law. Thus, an unreformed central bank, without a clearly stated objective of achieving and maintaining the stability of prices, was unable to contain inflation longer than it did.

On the more strictly economic front, the Marković reform programme was criticised on the grounds that it had delayed the implementation of stabilisation measures prior to the realisation of hyperinflation. Although hyperinflation was suppressed for some months following the implementation of the anti-inflation programme, it surged again in 1992, calling for stabilising measures. The "spectacular intrusions" into the monetary system by the republic National Banks, which by then represented only the branches of the NBY, definitely marked the end of the Marković programme. For reasons related to the military conflicts in Bosnia and Herzegovina and Croatia during the early 1990s and the dissolution of the SFRY, the transition was quickly interrupted.

The hyperinflation which from 1992 to 1994 reigned Serbia is now studied as the second highest (after the Hungarian hyperinflation, 1945-1947) and the second longest (after the Russian hyperinflation, 1922-1924) hyperinflation ever recorded in global monetary history. It was accompanied by an enormous reduction in GDP and productivity levels by up to 60 per cent. The authorities of the newly established Federal Republic of Yugoslavia intervened, however, only in January 1994, initiating the so-called Avramović programme. The programme was implemented against the background of an extensive regime of (non-)economic sanctions that were imposed on Serbia by the international community throughout the 1990s. The programme was again exchange-rate based, but *de facto* represented a currency board arrangement as all new money issue was fully backed by foreign exchange reserves.

Interestingly, the next wave of institutional central bank reform took place only in mid-1993 as a part of the belated institutional defining of the FRY. Our study did not discover any evidence pointing to the fact that this reform was a result of a conscious and deliberate act, although this law gave the NBY twice as much legal independence than it had under the previous law. The actual inflation record, however, made us conclude that this moderately high legal central bank independence was indeed insufficient to hold inflation from increasing further, on its own merits. Other policies, such as fiscal policy, were needed to sustain these negative economic tendencies. Also lacking was international support. As a result, the programme – which leaned more on personal credibility of Governor Avramović and the affectionate public support he had, than on a harmonised policy approach to transition and reforms – managed to bring down inflation in the first half of 1994. The second part of this programme, which began in summer 1995, and which was supposed to deal with trade liberalisation, increased competition and privatisation, was quickly abandoned and Governor Avramović was dismissed in May 1996.

In the following couple of years, the FRY economy was characterised by a reduction in the scope of production, import and export levels, and levels of investment and employment. The NATO bombing campaign, which lasted from 24 March until 9 June 1999, greatly added to the severity of crisis. Economically speaking, the losses were huge, as NATO targeted, in addition to military bases, some very important infrastructure objects (roads, bridges, airports, refineries, factories, etc.). The direct costs were estimated to amount from USD 1.2 billion to USD 11.7 billion, whereas the indirect costs were estimated at USD 30.3 billion, based on unrealised GDP for the period 1999-2010. Additionally, the FRY registered a full 18 per cent drop in GDP compared to the previous year, as well as a drastic decline in international trade of 36.5 per cent. At the same time, the unemployment rate *increased* by 27.7 per cent. Clearly, the transition was entirely suspended in this period and only resumed after the democratic overthrow of Slobodan Milošević's regime in October 2000. The conclusion nevertheless remains that without firm internal policy consensus *and* international support, no transition can be successful.

As of 2000 onwards, Serbia continued its transition by initiating an all-encompassing process of macroeconomic stabilisation, enterprise and banking system consolidation, restructuring and privatisation. International financial and political support largely eased this process, enabling Serbia to employ and direct its human and other potentials towards the common goal of transforming its society. Already in 2001, the FRY re-activated its membership in many international organisations and financial institutions (UN, OSCE, IMF, World Bank, etc.). Especially important for the country was the financial and political support of the European Union, which established a number of mechanisms to help the country overcome accumulated economic and other problems. Trade with the world intensified again and the first good results started being registered already in 2002. The analysis of this period points to the fact that even the events outside the scope of the fall of communism may act as a catalyst for an immense reform agenda, as suggested by Balcerowicz's argument of "extraordinary politics". The FRY's experience, however, also confirms that this period is limited, as the political capital gathered at such extraordinary time fades in line with increasing reform costs.

The first signs that there were problems in the implementation of the reform programme began appearing in 2003, when the debate about the fixity of the dinar exchange rate and about an ever-increasing current account deficit opened. This debate made us analyse a wide range of macroeconomic and other reforms such as price and trade liberalisation, balance of payment situation, fiscal and tax reforms, labour market and wage dynamics, as well as monetary, exchange rate and banking sector reform. The analysis showed that during the initial stabilisation phase (2001-2002), the NBS kept the nominal dinar exchange rate fixed, while the real exchange rate appreciated for 95 per cent. Such a huge dinar appreciation wiped out the possibility that Serbia's economic policy would focus on achieving sustainable growth. Instead, the focus was placed on short-term objectives, notably, on full exchange rate stabilisation and rapid disinflation. Already in 2003, it become clear that such a policy mix was dangerous in the sense that it tied the hands of the NBS to use the exchange rate depreciation as an instrument in settling external imbalances. On a strategic level, this meant that contemplation about the macroeconomic Maastricht criteria in Serbia is largely constrained by a more immediate need to contain domestic spending and real wage growth below productivity levels.

Our analysis, thus, points to the fact that the National Bank of Serbia will most probably continue targeting the exchange rate, as it had done traditionally. On a conceptual level, this indeed seems to be the preferred policy option at least until prolonged macroeconomic stabilisation is achieved. In this, however, the decision about the adequate degree of exchange rate flexibility must allow for a change of priorities, away from rapid disinflation to the resolution of existing external imbalances and increased competitiveness. The interviews that were conducted with the highest NBS officials, however, reveal that there may be different views and that the NBS may in the future engage more heavily in inflation targeting. Our analysis has revealed that the NBS, besides the fact that it targets the exchange rate, also targets inflation. Inflation targeting, however, appears to be the NBS's implicit monetary strategy. The literature review, as well as anecdotal evidence, suggests that the existing monetary framework is confusing both to the business community and to scholars. It is our view that this situation must be changed and cleared.

We strongly argue, though, that the decision about the new monetary policy framework cannot be formed intuitively by the NBS's management, or made in accordance with other countries' experience, without looking at the specificities of Serbia's economic milieu. In an attempt to underline the complexity of the monetary strategy formulation process, we devoted the entire Chapter IV to an analysis of the factors influencing this choice. Our main conclusion is that a comprehensive assessment of these factors and their relationship should be conducted before any further progress can be made. In doing so, it is likely that the NBS would require some technical assistance, which should most naturally come from one of the EU Member States' central banks or the European Central Bank itself. In the meantime, the NBS should try to gradually redefine its role in the financial market from a major player to a regulator of that market. An immediate challenge for the NBS would be to define its operating target interest rate and to restrain itself from daily interventions on the forex market. Instead, the NBS should find ways to encourage commercial banks to engage in the interbank market and to conduct operations among each other a lot more than they do atpresent. For this to be possible, an analysis should be done so as to detect the reasons for current banks' disengagement from mutual lending.

To be able to actively respond to the remaining transitional tasks, however, the National Bank of Serbia needs to restore its credibility. For that purpose, the legal NBS framework needs to be additionally strengthened. In order to assess the scope of anticipated changes in the NBS's institutional framework, we measured its *legal* and *actual* independence. The evidence obtained enabled us to perform cross-country and temporal analyses which revealed that the current NBS legislation – adopted following the constitutional change in February 2003, i.e. the establishment of the State Union Serbia and Montenegro – is in line with the transitional average, but that real NBS independence represents a cause for concern. Paradoxically, we also found that there is a tendency of the NBS to import personal credibility of the governors, although the evidence points that the rate of turnover of governors in Serbia is well below the threshold established by Cukierman (1992). We thus inquired into how this credibility can be restored and institutionalised.

We proposed that the matter be resolved by a new Serbian Constitution, arguing that a *collective* NBS governing body be established. Our proposal derives from an analysis of the NBY/NBS legal framework in the period 1989 to 2005 and the 1992 FRY Constitution, which was the legal basis for these laws. So as to prevent the inclusion of a "systemic error" into the new Serbian constitution – by which a single person (i.e. the governor) is the sole source of monetary policymaking – the study proposes several principles which may guide the drafting process. These include the necessity to establish the NBS as an autonomous legal entity, independent in the formulation and implementation of policies aimed at fulfilling its primary objective (presumably price stability), accountable to the National Parliament, and to ensure that the governor be dismissed by the parliament only for non-policy reasons. Also, we proposed that the status and organisation of the NBS be regulated by a law and that the NBS be given a constitutional right to propose laws in its domain. Only if these principles are respected, we believe, could the NBS's institutional credibility be restored. This, however, does not necessarily imply that all other mechanism ought to be neglected and that the general public may hedge against monetary misconduct by undertaking constitutional precautionary measures. We do argue, on the other hand, that a solid institutional basis for the NBS represents a precondition for full reparation of its credibility.

Furthermore, so as to underline the importance we attach to the NBS's own engagement in gaining public confidence, we proposed that the new Serbian constitution includes a provision regulating the mandatory presentation of a report on the activities and results of the NBS at least once annually to the National Parliament by the NBS governor. This simple exercise should allow the general public to actively engage in a discussion about monetary policy issues and to learn about what monetary policy can and cannot do in general. In turn, this learning process should introduce another quality in the conduct of the central bank's operations and its overall existence by ensuring that the central bank is held accountable only for those factors which it can influence. To put it differently, the aim of our proposal is to safeguard the central bank and its long-term credibility from short-lived popular government actions that bring immediate benefits to society, but which undermine the ability of central bankers to pursue a sustainable anti-inflation policy over the long term.

Moreover, this thesis analysed the provisions of the current NBS Law which would need to be brought in line with the EMU's *acquis*. We see the process of legal harmonisation with EU legislation as an additional opportunity for the National Bank of Serbia to improve its credibility. Apart from harmonisation with EMU provisions, we proposed that the NBS also replicate some of the practices developed by the ECB, such as greater engagement in presentation and pedagogical activities. Namely, we believe that a greater engagement of NBS high officials in educational activities focusing on explaining what monetary policy can and cannot do in general, both to the general public and to the political actors, may contribute to the strengthening of the NBS's reputation and credibility. Thus, we nominate the concept of transparency in the presentation of the NBS's monetary policy strategy and other tasks as a possible solution to this problem. A strong and clear constitutional and legal background, accompanied by a more practical and transparent presentation activities of the National Bank of Serbia, we believe, will allow for a shift from personal to collective policy preference, so crucial for further reforms. This is especially important when one takes into account the finding disclosed by this study – that an understanding about the E(M)U requirements in Serbia is still abstract and that the process of European integration is often overlooked and oversimplified. If Serbia is to join the EU, this will need to change.

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Appendix I

Table A4. *Legal variables and their codings*

Group	Definition of variable	Variable	Levels of independence and their meaning	Numerical codings
CEO	Term of office of CEO in years	*too*	1. *too* ≥ 8 2. 8 > *too* ≥ 6 3. *too* = 5 4. *too* = 4 5. *too* = 4	1 0.75 0.50 0.25 0
	Who appoints the CEO?	*app*	1. CEO appointed by CB board 2. CEO appointed by council composed of members from executive and legislative branches as well as from CB board 3. CEO appointed by legislative branch (Congress, king) 4. CEO appointed by executive branch (council of ministers) 5. CEO appointed trough decision of one or two members of executive Branch (e.g., prime minister or minister of finance)	1 0.75 0.50 0.25 0
	Provisions for dismissal of CEO	*diss*	1. No provision for dismissal 2. Dismissal possible only for nonpolicy reasons (e.g., incapability or violation of law) 3. Dismissal possible and at discretion of CB board 4. Dismissal for policy reasons at legislative branch's discretion 5. Unconditional dismissal possible at legislative branch's discretion 6. Dismissal for policy reasons at executive branch's discretion 7. Unconditional dismissal possible at executive branch's discretion	1 0.83 0.67 0.50 0.33 0.17 0
	Is CEO allowed to hold another office	*off*	1. CEO prohibited by law from holding any other office in government 2. CEO not allowed to hold any other office in government unless authorized by executive branch 3. Law does not prohibit CEO from holding another office	1 0.5 0

Table A4. ***Legal variables and their codings*** (continued)

Group	Definition of variable	Variable	Levels of independence and their meanings	Numerical codings
Policy formulations	Who formulates monetary policy?	*monopol*	1. CB alone has authority to formulate monetary policy 2. CB participates in formulation of monetary policy together with government 3. CB participates in formulation of monetary policy in an advisory capacity 4. Government alone formulates monetary policy	1 0.66 0.33 0
	Government directives and resolution of conflict	*conf*	1. CB given final authority over issues clearly defined in the law as CB objectives 2. Government has final authority only over policy issues that have not been clearly defined as CB goals or in case of conflict within CB 3. In case of conflict final decision up to a council whose members are from CB, legislative branch, and executive branch 4. Legislative branch has final authority on policy issues 5. Executive branch has final authority on policy issues, but subject to due process and possible protest by CB 6. Executive branch has unconditional authority over policy	1 0.8 0.6 0.4 0.2 0
	Is CB given an active role in the formulation of government's budget?	*adv*	1. Yes 2. No	1 0
CB objectives		*obj*	1. Price stability mentioned as the only or major goal, and case of conflict with government CB has final authority to pursue policies aimed at achieving this goal 2. Price stability mentioned as the only goal 3. Price stability mentioned along with other objectives that that do not seem to conflict with price stability (e.g., stable banking) 4. Price stability mentioned with a number of potentially conflicting goals (e.g., full employment) 5. CB charter does not contain any objectives for CB 6. Some goals appear in the charter, but price stability not one of them	1 0.8 0.6 0.4 0.2 0

Table A4. ***Legal variables and their codings*** (continued)

Limitations on leading	Limitations on advances	*lla*	1. Advances to government prohibited 2. Advances permitted but subject to limits in terms of absolute cash amounts or to other types of relatively strict limits (e.g., up to 15% of government revenues) 3. Advances subject to relatively accommodative limits (e.g., advances can exceed 15% of government revenues or are specified as fractions of government expenditures) 4. No legal limits on advances; their quantity subject to periodic negotiations between government and CB	1 0.66 0.33 0
	Limitations on securitized Lending	*lls*	Specification of levels identical to those for advances	
	Who decides control Of terms of lending?[a]	*ldes*	1. CB controls terms and conditions of government borrowing from it 2. Terms of CB lending specified in the law, or CB given legal authority to set these terms 3. Law leaves the decision about the terms of CB lending to government to negotiations between CB and executive branch 4. Executive branch alone decides the terms of CB lending to government and imposes them on CB	1 0.66 0.33 0
	How wide is the circle of potential borrowers from CB?	*lwidth*	1. Only central government can borrow from CB 2. Central and state governments as well as all political subdivisions can borrow from CB 3. In addition to the institutions mentioned under 2 public enterprises can borrow from CB 4. CB can lend to all of the above as well as to the private sector	I 0.66 0.33 0
	Tipe of limit when such limit exists	*ltype*	1. Limit specified as an absolute cash amount 2. Limit specified as a percentage of CB capital or other liabilities 3. Limit specified as a percentage of government revenues 4. Limit specified as a percentage of government expenditures	1 0.66 0.33 0
	Maturity of loans	*lmat*	1. Maturity of CB loans limited to a maximum of 6 months 2. Maturity of CB loans limited to a maximum of one year 3. Maturity of CB loans limited to a maximum of more than one year 4. No legal upper bounds on the maturity of CB loans	I 0.66 0.33 0
	Restrictions on interest rates[b]	*lint*	1. Interest rate on CB loans must be at market rate 2. Interest rate on CB loans to government cannot be lower than a certain floor 3. Interest rate on CB loans cannot exceed a certain ceiling 4. No explicit legal provisions regarding the interest rate on CB loans 5. Law stipulates no interest rate charge on government's borrowing from the CB	1 0.75 0.50 0.25 0
	Prohibition on lending in primary market	*lprm*	1. CB prohibited from buying government securities in primary market 2. CB not prohibited from buying government securities in primary market	1 0

Notes: (1) Computerized legal data files on CB charters from the Central Banking Department at the IMF, (2) Aufricht (1961, 1967), (3) Eight European central banks (1963), and (4) Effors (1982). These sources were supplemented by updates of various laws from the IMF legal library files.

a. Terms of lending concern maturity, interest, and amount of loans subject to the relevant legal limits.

b. The rationale for the classification of this variable is that minimum rates are likely to have been devised in order to discourage borrowing at the CB while maximum rates are probably meant to facilitate borrowing at the CB. But the requirement of a minimum rate is classified below "market rates", since minimum rates, when they exist, are usually lower than market rates.

Source: Cukierman (1992, pp. 373-376)