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Development of Inflation in South Eastern European Countries

Albania

The average annual CPI in 2004 in Albania was 2.9 percent, which was well within the target range of 2 to 4 percent, set by the Bank of Albania. From August until December the annual inflation rate stayed below 3 percent, with inflation reaching only 2.2 percent in December.

A combination of factors contributed to the favorable inflation performance of Albania in 2004. First of all, the stable macroeconomic environment played a role, with prudential monetary and fiscal policy during the year. Fiscal objectives were accomplished both in terms of budget expenses, as well in terms of the budget deficit. The government demand for loans increased during the second half year, but it stayed within the forecasted levels. The development in agricultural production and foodstuff prices (which has a 42.6 percent weight in the consumer basket) also strongly contributed to the low level of inflation in 2004 in Albania. The continuous effect of the decline in agricultural prices acted as a break on the effect of the oil price rise and delayed the effects of the administrative price changes. In January the price of electric energy has risen, while in April the price of fixed telephony (which was increased earlier) has been reduced (although the reduction was smaller than the increase). The prices of clothes and footwear declined during the second half of the year, while there was an increase in the prices of hotels, bars and restaurants, as well as in the price of education service.

For the year 2005 a 3 percent annual average CPI is expected, while the target range of 2 to 4 percent CPI is to be maintained by the Bank of Albania. Fiscal policy is expected to remain prudent. Money supply growth will be kept at levels close to nominal GDP growth.

Bulgaria

CPI rose significantly in the year 2004 compared to 2003. In the former year average inflation was on the fairly low level of 2.3 percent, while in 2004 it rose to 6.1 percent. The rise in CPI was primarily determined by the following factors: the adjustment of administratively set prices of goods and services, international crude oil prices, and prices of bread and cereals, which significantly rose at the end of 2003. The general non-food price index (excluding fuels) stayed stable. By the end of 2004 the inflationary pressure caused by high food prices and the prices of raw materials eased. At the same time the Bulgarian National Bank was making efforts during the year to curb the rapid growth in lending. It is expected, that in 2005 CPI in Bulgaria will start decreasing, however further price and tax adjustments prior to EU accession will put further pressure on the CPI, which will have reached about 4.5 percent on average by the end of the year.

Croatia

Inflation in Croatia has been on a low level in recent years. In 2002 yearly average CPI was 2.3 percent, in 2003 it reached 1.8 percent, while in 2004 it increased to 2 percent. There was a slight upward trend in year on year inflation at the end of 2004, which was followed by a slowdown in January, which is likely to be the result of the base-period effect. Producer prices have been on a downward trend since November 2004. Wage increases and higher oil prices have already made their effect on producer prices during 2004. Producer price inflation fell by 1.9 percentage points in January compared to October 2004. At the same time producer price inflation, which averaged 3.8 percent during 2004 (compared to the 2 percent CPI) is still expected to put pressure on consumer prices during 2005. Yearly average CPI is expected to increase in 2005 compared to 2004, to 2.7 percent.

Macedonia

Inflation in Macedonia has been under 2 percent since 2002, when the yearly average CPI reached 1.8 percent. In 2003 a further reduction occurred, with a 1.2 percent yearly average CPI. The low level of inflation is in large part the result of the de facto pegging of the Denar to the Euro. In 2004 CPI was only -0.3 percent, thus consumer prices decreased on average during the year. The main reason for the deflation was the reduction of food costs, as the price of imported food products decreased as a result of lower customs duties after the admission of Macedonia to the WTO and the creation of conformity with the EU's Stabilization and Association Agreement. An increase in inflation is expected to occur in 2005, with a 2.5 percent yearly average CPI.

Romania

The disinflation process continued in Romania in 2004. The average yearly inflation was 11.9 percent. There was a temporary rise in inflation during the summer, but by November year on year inflation had been for the first time in single digit levels since the beginning of the transition process, reaching only 9.9 percent. In December the decreasing trend continued with a 9.3 percent year on year inflation level. The disinflation process was supported by the strong Leu, a 0.4 percent cut in administered prices, and the reduction of the world oil price. In January 2005 monthly inflation change was 0.8 percent, slightly higher then the level experienced in November and December 2004 (both 0.6 percent). However, there was a further reduction in CPI compared to the same period of the previous year, to 8.9 percent. Until the end of 2005 a further reduction in inflation is expected, with yearly average CPI amounting to 8.8 percent.

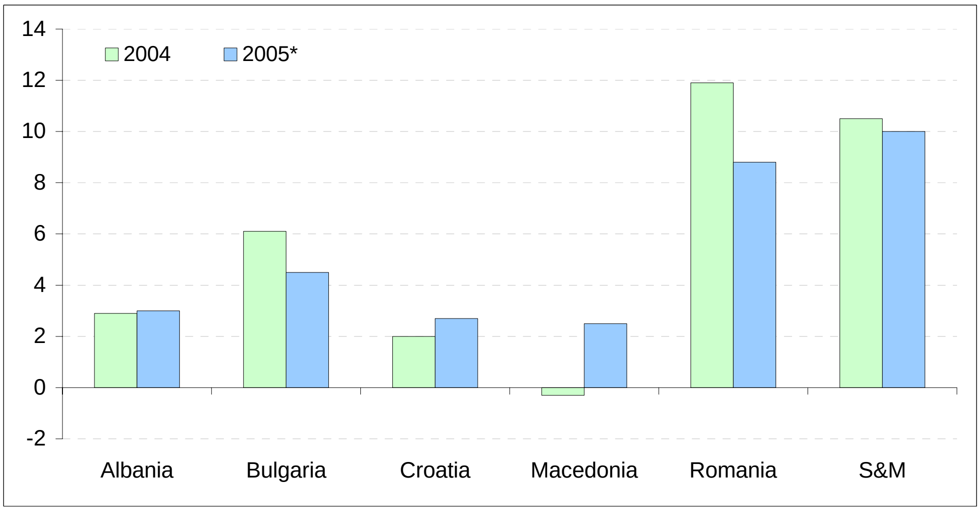
Serbia and Montenegro

Inflation in Serbia in 2004 was higher than earlier expected, reaching 13.7 percent in December, compared to the same month in the previous year. The main causes for such a large price rise were the surging price of oil and other primary products in the world market, and high growth of domestic demand. The most significant price rises occurred during the second half of the year. In the year 2003 CPI (7.8 percent) reached almost only half of the level experienced in 2004. The rise was observable both in industrial producer prices (4.6 percent in 2003 December, and 12 percent in 2004 December, year on year) and in core inflation (5.4 percent in 2003 December, and 11.5 percent in 2004 December, year on year). In order to reduce the currently high level of CPI, tightening fiscal, monetary and income policies is required, with fiscal consolidation playing the most important role. As the tax burden is already high in Serbia, fiscal tightening should come from expenditure savings. Limiting the pace of dinar depreciation is also important for reducing inflation in the short run.

In Montenegro inflation remains at a comparably lower level. In December 2004 year on year CPI reached 4.3 percent. The highest increase occurred in the price of telecommunication and insurance services, where the market is still characterized by monopoly and oligopoly.

The overall yearly average CPI of Serbia and Montenegro in 2004 was 10.5 percent. In 2005 it is expected to reach 10 percent.

CHART 1.
CPI IN SEE COUNTRIES (%)



**Projection*
Source: National Banks, and BA-CA

IMF Versus the Romanian Government

The International Monetary Fund (IMF) has always had great influence on the Romanian objectives about the budgetary deficit, and sometimes it brings forth conflicts between the Government and the international organization. It happened in the last few weeks as well: the Romanian government wants to plan with a higher deficit target than the IMF's recommendation.

Bucharest is aiming for a deficit of between 0,7 and 1,0 percent, but the IMF is insisting on a budget deficit of no more than 0,5%. Negotiations between the Romanian government and the organization are at standstill and Romania has given itself two or three months to convince the IMF to accept its aim, so the country can enhance its accession process to the EU.

Antecedendents

Romania was called by the European Union a well functioning economy in 2004. The growth level of the prices stood at 8,9% in January of 2005. The country's capability of attracting capital has picked up, thereby the faster level of privatisation of the last year has played a big role. But there were still problems with the current account deficit in 2004. The shortage grew by 35%, to 3,27 billion EUR in the first 11 months of the last year. The main reason could be found in the trade of balance.

On December 29, 2004 the Romanian Parliament accepted a new tax system. That means: from 1. January, 2005 the key of the income and the corporation tax is reduced to 16%. The IMF thought that the tax reform could be effective, however it was worried about the new, lower level of the taxes, because by its calculations the reducing of the rate would make the revenue lower by 1 percent of GDP, so it said, it would be needed to increase the VAT of some products. Nevertheless, the IMF has insisted on a budget deficit of 0,5%, and has suggested an aggravation in the fiscal policy. But it is clear that this level is more difficult to achieve using the new tax system, so Bucharest wants more leeway. The Romanian Minister of Finance, Ionut Popescu outlined that the government needs a higher budget deficit to finance some infrastructural programs with the assistance of the European Union.

Table 2.

The Balance of Payments in 2003 and in 2004 in EUR millions (provisional data)

ITEM	2003 Credit	2003 Debit	2003 Balance	2004 Credit	2004 Debit	2004 Balance
I. Current Account (A+B+C)	**20.940**	**24.000**	**-3.060**	**25.055**	**29.457**	**-4.402**
A. Goods and Services	**18.285**	**22.178**	**-3.893**	**21.838**	**27.374**	**-5.536**
a.Goods fob (exports-imports)	15.614	19.569	-3.955	18.935	24.258	-5.323
b. Services	2.671	2.609	62	2.903	3.116	-213
Transportation	1.063	997	66	1.252	1.206	46
Tourism - travels	396	423	-27	406	434	-28
Other services	1.212	1.189	23	1.245	1.476	-231
B. Incomes	**327**	**1.522**	**-1.195**	**326**	**1.689**	**-1.363**
Compensation of employees	98	6	92	91	5	86
Direct investment income	10	796	-786	5	887	-882
Portfolio investment income	153	228	-75	167	256	-89
Other Capital investment	66	492	-426	63	541	-478
C. Current Transfers	**2.328**	**300**	**2.028**	**2.891**	**394**	**2.497**
Government Sector	235	36	199	171	45	126
Other sectors	2093	264	1829	2720	349	2371

Source: National Bank of Romania

Relation Between Romania and the International Monetary Fund

Romania has been a member of the IMF since 1972. Its quota is SDR 1,03 billion. Since 1972, Romania has used the IMF resources on 9 occasions to support the government's economic programs. Starting in1991, the financial assistance granted by the IMF has materialised in the approval of several Stand-by Arrangements.

On March 25, 1998, Romania accepted the obligations under Article VIII of the IMF's Articles of Agreement on current account convertibility, wherein the country is engaging itself neither to impose restrictions on payments and transfers pertaining to current international transactions, nor to accept discriminatory foreign exchange arrangements or multiple foreign exchange practices, without the IMF's approval. The IMF has always outlined the necessity of the tight fiscal policy in Romania, and it was always the key of the debates about the current or budgetary deficit between them. Nevertheless, the IMF evaluatedated the Romanian macroprocesses positive yet in July, 2004. The directors of the organization acknowledged the improving of the equivalent-indicators and the process of the privatization.

On July 7, 2004 the Ececutive Board of the IMF consented the 10. arrangements, a 24-month Stand-By Arrangement for an amount equivalent to SDR 250 million. Total Fund credit and loans outstanding at end-June 2004 amounted to SDR 337,00 million, 32,7% of quota. The IMF has provided Romania with technical assistance in a number of areas, including tax and customs, monetary policy and central bank organization, banking supervision and in statistics.

IMF: Is It a Necessary Thing? – A Romanian Example

In some opinions the influence of the IMF on the Romanian economy is too much. But more and more opinions could be heard about the inefficiency of the organization, but certainly there are economists who outline, that there are no problems with it. Which is the right opinion? Is there a right opinion?

It is undoubted that since the outbreak of the Asian financial crisis, it has been open season for attacks on the International Monetary Fund. Since the crisis in 1994 a consensus has grown that IMF rescue packages are a major source of moral hazard. It is the biggest problem, which the IMF is blamed for. The moral hazard arises because financial assistance to countries hit by financial crises results in private-sector investors being less cautious in the belief that the Fund will always ensure they are repaid. So it is an existing problem, and it is not easy, but it could be solved. The answer to these problems could be to ensure private-sector participation in any future crisis: investors must bear at least some of the costs of crises. There are a lot of negative opinions and worries about the IMF, but it is not a question, who needs it:

„In a globalized economy everyone needs the IMF. Without the IMF the world economy would not become an idealized fantasy of perfectly liquid, completely informed, totally unregulated capital markets. Investors and lenders would still make decisions on the basis of imperfect information, and they would have to take into account the absence of an international lender of last resort." – the former chairman of the Chase Manhattan Bank, David Rockefeller said. And its loans have already helped many countries. For example *Romania*.

In early 1999, having confronted with the threat of an impending crisis, the authorities returned a verdict to stabilize the economy, which were supported by a stand-by arrangement *with the IMF*. The economic program encompassed strong fiscal correction, an improvement in external cost competitiveness, tight monetary and income policies, and the closure of a large insolvent state bank. These policies succeeded in putting away the crisis in mid-1999, reducing the current account deficit to a sustainable level and strengthening foreign reserves. It also helped to restore market confidence.

So it will always be a big question and an issue for the contests among economists, whether the IMF has to be reformed or not, or where the bound of its activity is, but the majority will perhaps always stand by the effectiveness of International Monetary Fund, and never challenge the big role of its loans for the emerging economies to catcu up with the developed ones. And it could happen that sometimes the organization draws up strickt objectives for the countries, but these could appoint the right direction for the reforms. Its assistance has the mainstay of Romania not once in the last years as well.

About the Future:

The Romanian objective for the future is to be the member of the EU in 2007. The government is waiting for a higher economic growth level for 2005 than the 5,3% expected by the IMF. Bucharest thinks that the International Organization is worried about the Romanian revenues needlessly. Analysts expect IMF officials to accept a higher deficit, so as they see, that will not influence Romania's EU accession. While the IMF was discussing the deficit, with the Romanian officials, Brussels was not concerned with this issue. The EU diplomats think that the IMF was too strickt about technical issues, and the real reform is what really matters in the economy. In principle, the negotiations with the country and the organization will restart in 2, 3 or 4 months.

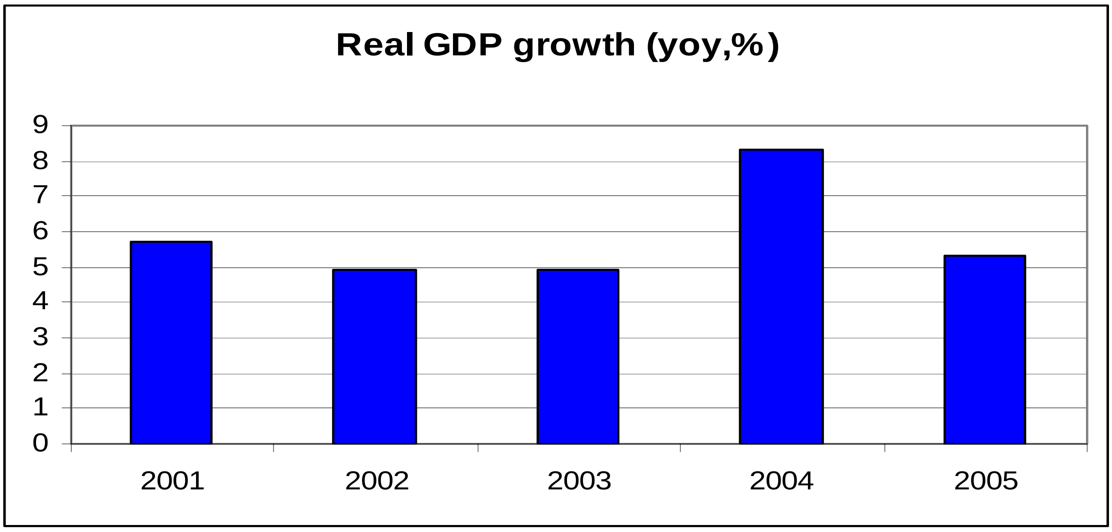
8.3% GDP Growth in 2004 in Romania – Positive Signals for Investors

The Romanian economy seems to show impressive progress, as we have a look at its main macroeconomic indicators. This probably will enhance the country's accession process to the European Union. Taking all these into consideration, Romania can be an ideal target for investors. To draw a complete picture, some threats must be mentioned.

8,3% GDP Growth

Romanian real GDP grew by 8.3% in 2004, which is a significant achievement, considering the fact that a year ago this figure showed „only" 4.9%. The GDP accounted for ROL 2 387 914.3 billion in 2004. The growth was mainly the result of the higher activity volume, consequently the gross value added in agriculture, forestry, fish breeding and construction.

Chart 3.
Real GDP Growth, (yoy, %)



Source: www.insse.ro

On the production side, **agriculture** was one of the main engines that contributed to this high growth level. Though last year the sector had to face problems, the agriculture's 22.2% growth in 2004 is still remarkable.

The **construction** sector advanced with 8.9%, compared to the previous year. 62.4% of the total was new construction work, 15.8% was capital repair work and 21.8% represented maintenance and current repair works.

The growth of **industry** was 5.3% year on year (in 2003, this index was 3.1%), thanks to the gains in the output of the intermediate goods (15.1%), durables (8.7%) and capital goods (6.1%). The output of non-durables showed a drop of 2.8%. The uptrend in output of industry is expected to continue.

Labour productivity was significant in most of the sectors. Industry increased by 11.9%[1], while this index shows a 7.3% growth for mining, 13.3% for manufacturing and 0.5% for the energy sector.

[1] Percentage change versus the same year-ago period.

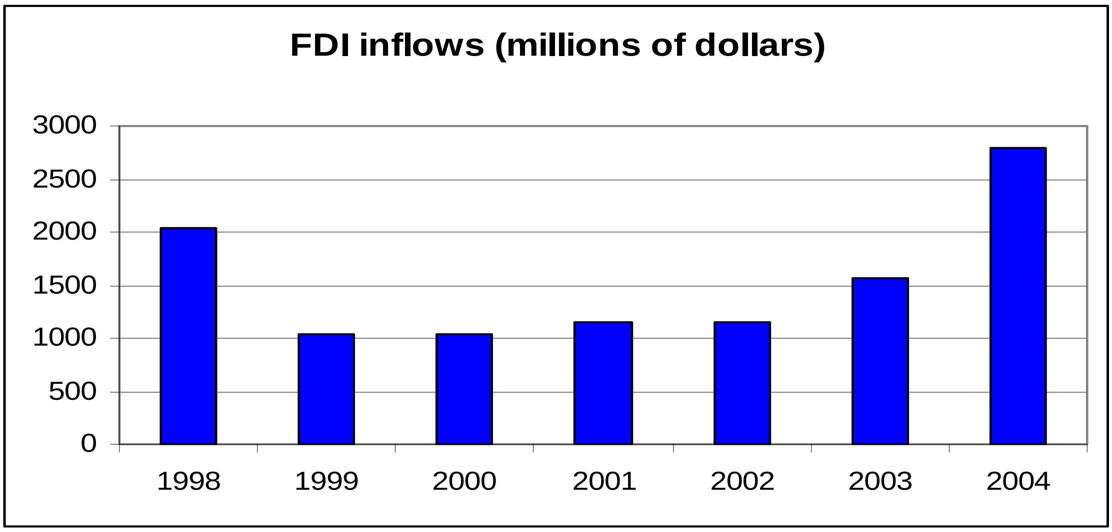
In 2004 the **consumption** side grew by 10.3% in comparison with 2003, mainly due to the 9.6% real increase in wages, the remarkable growth of credit both in the household (58.3%) and the business sector (31.3%), and the decreasing unemployment rate (from 7,6% in 2003 to 6,8% in 2004). In 2004 elections took place, which also had a positive impact on consumption.

The **retail** sector took advantage of the increasing consumption and the retail sales grew by 17.6%. In 2003 this index was 5.7%.

Investment increased in real terms by 8.2% in comparison with 2003. Gross fixed asset investment growth was 10.1%, mainly as an effect of the restructuring and privatisation of the enterprise sector. In 2004 the privatisation accelerated, especially due to the positive attitude of the government towards it – the main transactions took place in the energy sector. According to the plans, in 2005 the telecommunication sector will be tendered.

Regarding the **FDI** (foreign direct investment) a rapid increase could be observed. In 2004 the value of the inward FDI was approximately USD 2800 million and for 2005 there is expected further growth. The rise of capital inflow is the result of the improvement in the stability of the economy and the better credit rating. Also the nearby EU accession has a positive impact on the FDI inflows. Another key factor is the confidence in the new government's policy.

CHART 4.
FDI INFLOWS (MILLIONS OF DOLLARS)



Source: www.unctad.org

The current account deficit picked up 43.9% year on year to EUR 4.402 million. The widening trade deficit is the main explaining factor of this index. In 2004 export grew by 21.3% year on year, but import increased more rapidly, by 24%.

Compared to the end of 2003, **consumer prices** came in at 9.3%, which is 0.3% above the national bank's inflation target. 2004 was the first year to have a single-digit rate. According to the National Bank of Romania, the key factors that contributed to disinflation were the nominal strengthening of the domestic currency and the 0.4% cut in administered prices.

CONCLUSIONS

In 2004 Romania showed one of the biggest GDP growth in the region. In this year, the analysts predict a GDP growth of 5.2-5.3%. The new tax system should have a positive effect on it. One of the aims of the tax reform is to make the Romanian economy more attractive for the investors and to reduce the size of the „black economy”.

It must be mentioned that these positive parameters are optimistic regarding the size of Romania, but we must notice that for a poorer country it is much easier to produce a higher growth index. No predictions can be made for the long term economy increase, but the short term tendencies are definitely positive.

Taking into consideration the parameters of the Romanian economy, it must be mentioned that the high level of the current account deficit and speculative investments represent a hazard.

Step-by-step reforms have been made to support the economy, but certain elementary problems still exist and maybe cannot be solved in the short term. Corruption can be found almost in all levels and in all fields. Another problem is the excessive bureaucracy. Sometimes it occurs that law is not applied. These are some of the problems that have to be solved in order to achieve a successful EU accession for Romania.

HIGHER INFLATION AND TRADE DEFICIT IN SERBIA

INFLATION

The two major problems of the Serbian economy are the relatively high inflation and the trade balance deficit. According to the National Bank of Serbia (NBS) strong and responsible fiscal policy, restrictive monetary policy and strict wage policy are necessary and postponement cannot be an option.

Unfavorable trends in last year are stimulating the NBS and the government to take more rigid measures in these questions than the IMF suggested.

Price stability is an important issue, because the effect of oil prices, electric energy prices share in total inflation is only 7,1%.

The inflation was 13,7% in 2004, and December's 2,5% shows an accelerating increase in prices- it may be related to the rising prices of services. By regulation of prices in electricity, utilities and other public services contributed to the overall retail price growth by 56% or 7.7 percentage points.

According to Governor of NBS, though there was even success in fiscal policy like the reduction of budget deficit to 1,7% of GDP in 2004. This decrease was achievable due to the fact that a part of the expenditures was postponed to this year.

In line with the objective the monetary policy of National Bank of Serbia was moderately restrictive, in the second half of 2004 the required reserves rate was raised from 18% to 21% in August to restrain the commercial banks' lending expansion and to reduce the pressure on foreign exchange reserves.

The main objectives of the NBS for 2005 henceforward will be the price stability, to keep inflation rate at one-digit level between 9 and 10%.

TABLE 3.
CORE AND OVERALL INFLATION IN THE REPUBLIC OF SERBIA (GROWTH RATES IN %)

	Dec 2002/ Dec 2001	Dec 2003 / Dec 2002	Dec 2004/ Sept 2004	Dec 2004 / Dec 2003
Retail prices				
Overall inflation	14,8	7,8	4,1	13,7
Core inflation	6,0	5,4	3,7	11,5
Cost of living	11,8	8,1	3,2	13,1
Goods prices	8,3	6,7	2,8	12,9
Services prices	40,1	16,9	5,1	14,2
Industrial producer prices	6,1	4,6	2,0	12,0

Source: NBS

WAGES AND BUDGET

The main problem is the regulation of wages. Namely the nominal increase of wages in public sector was 24% (12% real). The higher wages are economically rational and justified only by productivity, any other arguments are not acceptable. The NBS recommends to keep the public wages on 2004 level, the increase in wages would be only possible due to rationalization, which means jobs will be axed in the public sector. The Central Bank's position on this question is more radical than the government and IMF proposition. The NBS would keep the level of wages not only in the public sector (on republican, local governmental level), but also in public owned corporations

Control of wages is important in all major companies who have monopoly on the market, investing from foreign loans etc. The IMF and the Word Bank require of major public companies to cover their expenses and investments, which is not equal with the demand of increasing prices in these sectors. Companies need to rationalize their structure of expenses.

Nevertheless, the Council for Economy in the Ministry of Finance had resolved that wages in education and social protection institution would be increased by 20% for employees with Master's Degree and 12% for the ones with high school degree. The pension in March also increased by 11,7%

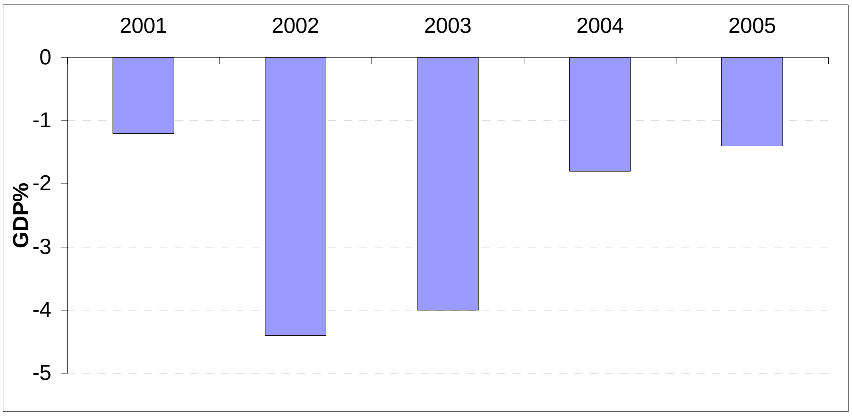
Serbia's overall public consumption reported in 2004 was too high as on the grounds of the preliminary data, the total consolidated public revenue was CSD 603,73 billion and expenditures reached CSD 625.22 billion or 48.3% of the GDP for 2004, namely it increased by 19.4% in nominal terms, and by 8.4% in real terms relative to 2003.

It is important that, after the fiscal policy measures had been applied, the fiscal deficit decreased in 2004 from the originally projected level of CSD 45.3 billion to CSD 22.4 billion - grants included - 1.7% of the GDP.

The performance of the 2005 budget goals will largely depend on the generated VAT revenues, which are really difficult to be anticipated as they are new to the country's fiscal system. VAT was introduced in Serbia on 1st January this year, the evaluation of VAT income is soon, while the small-taxpayer VAT payment is only expected in April. As a result of the measures to ensure budget tax revenues like intensive tax control the number of taxpayers was increased by 2000.

Minister of Finance Dinkic announced that the government planned a series of laws to regulate the financial market, like banking and insurance.

CHART 4.
BUDGET DEFICIT



Source: Ministry of Finance

TRADE DEFICIT

The ratio of export in imports fell from 38,2% to 35,6%, the export increase was lower than in the value of import, this tendency shows that the deficit increased in absolute and in relative terms.

The overall foreign trade (export and import) increased 43,7% in 2004, the percentage of the external sector in the country's overall economic activity increased, Serbian economy strengthened its openness to the world.

In 2004 the country's overall balance of payments recorded a surplus of USD 694 million equal to the increase in the NBS foreign exchange reserves from December 2003 to December 2004.

Analysts pointed out the fast liberalization of customs regime: since 2000 basically all kinds of products can be imported and this could be the cause of high trade deficit.

TABLE 4.
BALANCE OF PAYMENTS OF THE REPUBLIC OF SERBIA
(IN MILLION U.S. DOLLARS)

	2003 Jan-Dec	2004 Jan-Dec	Index
I. CURRENT BALANCE	-1 758	-2 927	166,5%
Merchandise Trade, net	-4 618	-7 047	152,6%
Exports	2 855	3 897	136,5%
Imports	-7 473	-10 944	146,4%
Services, net	289	405	140,1%
Exports	1 007	1 487	147,7%
Imports	-718	-1 082	150,7%
Interests, net	-208	-220	105,8%
Current transfers, net	2 304	3 411	148,0%
Public Grants	476	525	110,3%
II. CAPITAL BALANCE	2 595	3 183	122,7%
Foreign direct investments, net	1 360	966	71,0%
Medium and long-term loans, net	991	1 521	153,5%
Short-term credits and deposits, net	14	239	1707,1%
Commercial banks, net	-102	-16	15,7%
Other, net	332	473	142,5%
III. ERRORS AND OMISSIONS, net	432	437	101,2%
IV. OVERALL BALANCE (I+II+III)	1 270	694	54,6%
V. NBS FOREIGN EXCHANGE RESERVES (increase-)	-1 270	-694	54,6%

Source: NBS

EU AND SERBIA

Serbian international obligations have favourable achievements, since during one month six defendants was handed over to Haag UN tribunal. If Serbia fulfils the conditions and two more generals will be handed over, the EU will value the Feasibility Study positively, which means that Serbia could start the pre-accession negotiation.

SUMMARY

The major challenge for Serbia is to lead strict fiscal policy especially in relations of wages in the public sector. Restrictive monetary policy is desirable. Serbian international political judgment can be valued favourably if the government fulfils the condition and hands over war criminals.