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Economic transformation of the Western Balkans and Eastern Europe – lessons learned

Western Balkan and Eastern Europe countries[1] can, to a large extent, be considered as a European success story. Over the past two-three decades, they enjoyed a rapid convergence towards higher income European countries. However, recent shocks, such as the pandemic and Russian invasion of Ukraine have been causing deep and negative economic consequences for the region.

Earlier this year we organized technical cooperation with colleagues from Western Balkan and Eastern Europe countries and discussed the current monetary policy challenges and policies we use to manage inflation over the last year(s). It appears that each country has its own story on headline and core inflation and wages, but there are several common features. This text reflects our discussions and inputs from our participants.

The countries of the Western Balkans and Eastern Europe went through a major economic transformation over the past 15 years

Many are unrecognizable compared with where they stood at the turn of the century. The observed progress was accompanied by rising incomes and living standards. Perhaps the most tangible achievement is the fact that most of the Western Balkan countries are on a path towards European Union accession, something that seemed far off in the 1990s (**Chart 1**). Indeed, six countries (Albania, Bosnia and Herzegovina, Moldova, Montenegro, North Macedonia, and Ukraine) are being EU candidates and two countries (Georgia and Kosovo) are potential EU candidates. Currently, most of these countries are facing multiple unprecedented economic shocks, starting with the pandemic, followed by the war in Ukraine, and a period of high inflation.

Inflation has peaked at multi-year highs through 2022 in the Western Balkan and Eastern Europe economies

Average annual consumer price inflation ranged from 6.8% in Albania to 28.6% in Moldova, peaking at highs not seen in over a decade in autumn 2022. Inflation in most countries accelerated significantly faster than in the euro area (**Chart 2**). All countries are currently experiencing a decline in inflation. Countries with inflation targeting[2] are gradually moving back towards their inflation objectives (**Chart 3**). Most economies are expected to return back to their targets by the first half of 2024. For example, in Georgia, inflation has even dropped below its target level and is expected to approach it from below in the medium term (**Chart 3**, dark green line).

Chart 1: Western Balkan and Eastern Europe countries – EU accession status

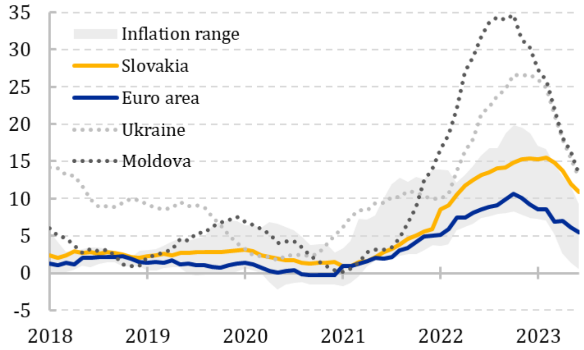
Source: European Union website.

[1] Western Balkan and Eastern Europe countries comprises selected countries from the Western Balkans (Albania, Bosnia and Herzegovina, Kosovo, Montenegro, and North Macedonia), countries from the Commonwealth of Independent States (CIS) (Azerbaijan and Moldova) and other countries in Eastern Europe (Georgia and Ukraine).
[2] Albania and Georgia have the most similar targets to advanced countries, aiming for 3% inflation, followed by Azerbaijan targeting 4% inflation. On the other hand, Moldova and Ukraine have the highest targets in the region, with a goal of 5% inflation. However, not all of these countries solely focus on inflation as their goal. Some countries, like North Macedonia, target exchange rates, while others prioritize financial stability or keeping the value of their own currency stable.

Similar to the eurozone, the main drivers of inflation in these countries are food (Chart 4) and energy price inflation

Food prices have had a significant impact, accounting for approximately half or more of the overall inflation. The reason is, that they hold a larger weight in the consumer basket (**Chart 5**) compared to the euro area or Slovakia, ranging from about 31% (Montenegro) to 40% (North Macedonia). The higher weights of food in the consumer basket in Western Balkan and Eastern Europe countries are consistent with their higher headline inflation compared to the eurozone (**Chart 2**). Most of these countries rely on food imports, which makes them vulnerable to global price changes. In addition to international commodity market trends, various factors have affected food prices in these countries. For instance, a severe drought in 2022 had a negative impact on harvests in Bosnia and Herzegovina. On the other hand, Albania, and Montenegro, relying heavily on tourism, experienced a successful tourist season, leading to increased demand for food. Regarding housing, the increased numbers of long-term visitors to Georgia from Russia, Belarus, and Ukraine sharply and instantaneously pushed up rental prices in the local market, putting further pressure on inflation. Housing, including fuel and power, was the second main driver of inflation, followed by transportation. High prices of food, housing, energy, and transportation pose challenges for households, as these items form a large part of their expenses, leading to higher costs for essential needs.

Chart 2: Inflation range in Western Balkans and Eastern Europe countries in comparison with inflation in the Euro area and Slovakia (year-on-year, in %)



Source: Haver, NBS calculations. Ukraine and Moldova are put outside of the range since Ukraine is in a war and Moldova is heavily dependent on energy.

Chart 3: Individual countries inflation and their inflation targets (year-on-year, in %)

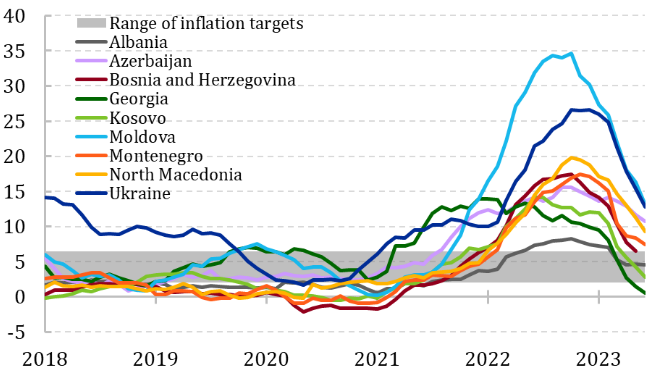
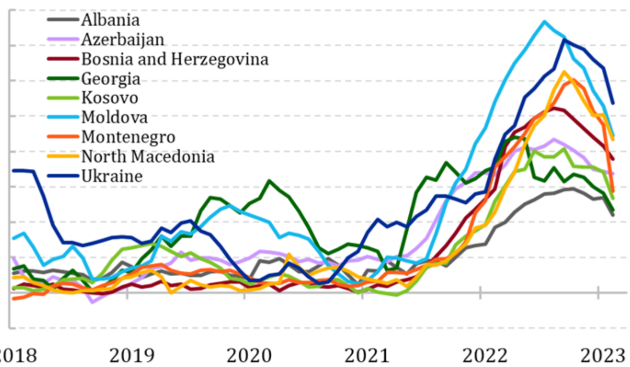


Chart 4: Food inflation (year-on-year, in %)

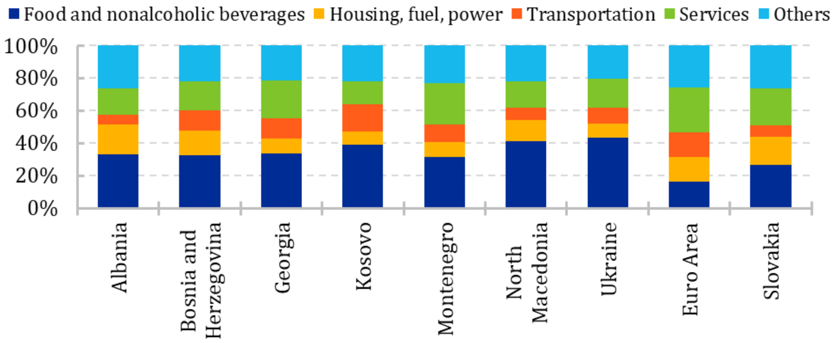


Source Chart 3 and Chart 4: Haver.
Note Chart 3: The range of inflation targets displayed represents the span between the lowest tolerated inflation (2%, Azerbaijan) and the highest tolerated inflation (6.5%, Moldova) among the analysed countries that have defined explicit inflation target along with tolerance bands.

During the post-pandemic recovery, economies in the Western Balkans and Eastern Europe countries experienced strong increases in wages (Chart 6)

As the job market improved, unemployment rates declined, and more people were able to find a job. To support workers, some countries raised the minimum wage. Furthermore, certain industries, such as IT, healthcare, construction, manufacturing, transport, and tourism, faced a shortage of workers. All of these factors pushed wages higher, especially in the private sector. However, in some countries, nominal wages didn't rise enough to keep up with the increasing prices of goods and services. This led to negative real wage growth. This had an impact on consumers' purchasing power,

Chart 5: Weights in the consumer basket (in %)

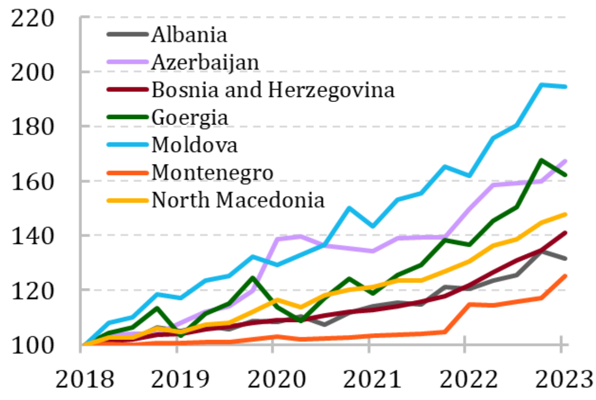


Source: Haver, NBS calculations.
Note: Category Services contains Health, Education, Communication, Recreation and culture, Hotels, coffee houses and restaurants. Category Others contains Alcoholic beverages and tobacco, Clothing and footwear, Furniture, household goods and maintenance, Miscellaneous goods and services. All data presented is for the year 2023, with the exception of two countries. Montenegro has the latest available data from the end of 2022, and Bosnia and Herzegovina has the latest available data from the year 2021.

making it harder for people to afford things they need. As a lot of households in these countries have to spend a significant share of their average monthly income on necessary monthly expenses, food prices played a crucial role in affecting both prices and wages. The high cost of food can impact wage setting behaviour and can create wage-price pressures.

Despite the potential risk of wage-price spirals, overall inflationary pressures appear moderate in the region due to the expectation of moderating economic growth and tighter policy measures.

Chart 6: Earnings (index, 2018Q1=100)



Source: Haver.

Fiscal policies played a crucial role in providing support to the economies

The primary objective of fiscal policies is to limit the impact of the rising cost of living for households and the increasing input costs for businesses. However, it is essential to carefully consider the implementation of fiscal measures to avoid cases like one of Montenegro, where fiscal expansion has contributed to increased inflationary pressure. To avoid contributing to inflation, fiscal support should be temporary, aimed at helping vulnerable groups and promoting energy efficiency.

Box: How does the exchange rate regime affect monetary policy?[3]

Most of the countries has relied on the existing set of monetary policy tools to manage and control inflation during the crisis. The national central banks have adapted a range of various measures to bring the inflation back to target. Most common measures in these countries are open market operations, standing facilities[4], and minimum reserve requirements. These tools allow the central bank to influence the money supply, interest rates, and overall liquidity in the economy. To address the situation of high inflation, monetary policy measures were tightened and policy rates have been increased in countries with independent control over monetary policy.

The exchange rate stability is one of the key factors that has a powerful effect on price levels. The exchange rate is a main anchor of the monetary policy and a key anchor of price stability in Azerbaijan and North Macedonia. Thus in Azerbaijan a sustainable exchange rate of the national currency plays a vital role to contain inflation and its main elements as well as its balancing role is considerably neutralizing foreign origin inflation and expectations.

Control over monetary policy is markedly influenced by country's exchange rate regime. Limited control over monetary policy is seen in countries such as Kosovo and Montenegro, where official euroization is in place, or in Bosnia and Herzegovina, which operates with a currency board. However, even in countries with their own currency and a floating exchange rate regime, there is usual trend of high unofficial euroization (or dollarization). Unofficial euroization (dollarization) is considered to be one the main challenges and constrain of monetary policy implementation. It also contributes to the weakening of the currency positions of the banks. To a certain extent, it can reduce the effectiveness of monetary policy transmission as the countries are able to affect local currency interest rates through their policy rate, but not the foreign interest rates. In these cases, efforts should continue to reduce the use of foreign currencies, as it can pose risks to financial stability and limit monetary policy choices. The role of fiscal policies was even more pronounced in countries with limited control over monetary policy.

[3] We thank participants from the technical cooperation on Monetary Policy in Challenging Times for their inputs.
[4] Overnight loans or certificates of deposit offered by the National central bank to banks.

Official euroization
Official euroization refers to a situation where a country outside the eurozone adopts the euro as legal currency and official currency, replacing its national currency. In this system, the country's monetary policy is controlled by the European Central Bank, and it uses the euro for all its transactions and financial activities.

Unofficial euroization
Unofficial euroization refers to a situation where a country uses the euro as a widely accepted currency for transactions and savings, even though it is not the country's official currency. In this case, the country still retains its national currency, but the euro is commonly used in everyday economic activities.

Currency board
A currency board is a monetary system in which a country's central bank is required to hold a fixed amount of foreign currency (usually a reserve currency like the U.S. dollar or euro) for every unit of its national currency in circulation. The value of the national currency is backed by the foreign currency reserves, and the exchange rate is fixed. The currency board system aims to provide stability and confidence in the national currency by ensuring a fixed exchange rate with the reserve currency.