Why Fighting Inflation should be the Western Balkans' Top Priority right now

The Western Balkans have seen up to 80% higher regional headline inflation than the Euro area. A research paper by the IMF covers the reasons for the higher inflation in the Western Balkans.[1] Decisive policy action to bring inflation back to target is needed to avoid inflation expectations becoming dangerously de-anchored like in some other emerging market economies. This needs to be the top priority right now, as headline and core inflation are stubbornly above target, even though they have started to slow in most of the region.

Inflation is a particular challenge for the Western Balkan region due to its higher poverty rates. Unless offset by productivity gains, sustained higher inflation also implies a potential loss of competitiveness considering the fixed exchange rate regimes in the region in the form of a currency board (Bosnia and Herzegovina), peg (North Macedonia), stabilized exchange rate regime (Serbia) and unilateral euroization (Montenegro and Kosovo). The region's hyperinflation past, institutional challenges and the more limited toolkits of the central banks due to the exchange rate regimes suggest that inflation may stay higher for longer.

The role of monetary policy

As long as the path of inflation remains above targets, central banks in the region will need to continue tightening to prevent a de-anchoring of inflation expectations and ensure that inflation falls all the way back to targets. Yet, central banks have been hesitant to raise policy rates further in order to protect growth. However, there cannot be robust and sustainable growth without price stability. Failure to act decisively now could force even greater tightening and slower growth down the line.

Policy rate increases send an important signal about central bank resolve to tackle inflation, which is critical in containing additional second-round effects. This is true even though it is often argued in the region that widespread euroization and excess banking sector liquidity weaken the transmission. The central banks in unilaterally euroized economies also have tools and should use them. These include increasing the renumeration of mandatory/excess reserves closer to the ECB deposit facility rate and prudential and administrative measures that influence the volume and quality of lending.

Continued vigilance is imperative while interest rates rise, and global financial sector risks remain elevated. The financial sectors in the Western Balkans are in much better shape than at the time of the global financial crisis. Still, pockets of vulnerabilities exist related to ownership structures, a high share of variable interest rate loans, and in some countries large government exposures. Careful stress-testing, risk-based supervision and macro-prudential policies should be deployed where needed. Further, robust bank resolution frameworks and bankruptcy laws need to be in place to be able to deal with any potential risks. Also important is to avoid regulatory forbearance, which has recently been observed in some Western Balkan countries.

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[1] IMF (2023), Inflation Dynamics in the Western Balkans (https://www.imf.org/en/Publications/WP/Issues/2023/03/03/Inflation-Dynamics-in-the-Western-Balkans-530338)

In this context, the credibility of monetary policy and confidence in financial sector stability are key. This requires central bank independence and functionality to ensure that they have the capacity to do ‘whatever it takes’ to achieve their mandates. Some Western Balkan economies have recently experienced challenges in this respect, with acting governors, supervisory boards without quorum, legislative changes to the appointment procedure of central bank management, and media campaigns.

Fiscal and income policies need to be part of the solution—not contribute to the problem

Fiscal and income policies need to work together with monetary policy to support disinflation. It is especially important that they do not add to demand pressures in fixed exchange rate regimes, where central banks have more limited leeway to bring down inflation.

Wage growth is central to inflation and to inflation expectations and will need to be monitored and contained. Last year, even as real wages declined in the Euro area, wage growth in some Western Balkan countries surpassed inflation. Continued rapid wage increases, including in the public sector, as well as rising minimum wages—which are likely to spill over to further economy-wide wage increases—pose a material risk of making underlying inflation more persistent.

After loose fiscal policy during the pandemic, fiscal consolidation is needed, both to contain inflation pressures and to mitigate the impact of higher debt service costs. Tax cuts to reduce inflation should be avoided. Most countries in the Western Balkans have succeeded in resisting such cuts; others are in the process of reversing them.

On the fiscal spending side, policy makers will need to ensure only well-targeted and temporary support to the most vulnerable, especially those who are struggling with the cost-of-living crisis.

At the same time, electricity tariffs will need to be adjusted in line with market developments—despite the impact on inflation— to limit fiscal costs and to maintain price signals that contain demand pressures. Having all countries in the region aligned in adjusting their electricity tariffs will also help maintain a level playing field for the corporate sector of individual countries.

Administrative measures are just stop-gap measures; more sustainable reforms are needed

Administrative measures such as price and profit margin freezes and trade restrictions have been extensively employed in the Western Balkan region but are just stop-gap measures. In addition, the effectiveness has been challenging and they tend to have distortive impacts. Reforms to enhance competition are more sustainable and effective tools in the medium term. Such reforms include—for example—removing entry barriers for new businesses, significantly strengthening competition authorities, and introducing mechanisms to provide greater price transparency.