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ANALYSIS OF FISCAL AND MONETARY POLICIES COORDINATION IN MONTENEGRO

Abstract

To achieve the goals of economic policy, it is necessary to attain a high level of harmonization between monetary and fiscal policies and to establish adequate coordination between them, using both formal and informal arrangements. Countries with a stricter institutional division between the objectives and instruments for

monetary and fiscal policies conducting and with a developed financial market attain coordination between them mostly through the actions of market mechanisms. Formal arrangements are taking place and more expedient in the countries which do not have the necessary financial market depth, or the tradition of its proper functioning. In Montenegro, which has chosen the regime of euroisation, coordination of monetary and fiscal policies is more important than in the countries which have their own currency. Due to the lack of the market mechanisms action traditions, and the numerous imperfections and limitations of the financial market, the establishment of a formal arrangement would enhance the coordination between the monetary and fiscal policies.

Montenegro formally meets the greatest part of the recommendations in terms of institutional and operational arrangements necessary for coordination. Irrespective of that, the coordination of fiscal and monetary policy in Montenegro needs to be further improved.

Keywords: Monetary Policy; Fiscal Policy; Coordination; Euroisation; Public Debt; Formal Arrangements; Informal Arrangements.

JEL Classification: E52; E61; E62

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АНАЛІЗ КООРДИНАЦІЇ ФІСКАЛЬНОЇ ТА МОНЕТАРНОЇ ПОЛІТИКИ У ЧОРНОГОРІЇ

Анотація. У статті обґрунтовано, що для досягнення цілей економічної політики необхідно забезпечити високий рівень гармонізації між монетарною і фінансовою політикою держави та встановити між ними адекватне координування, використовуючи як формальні, так і неформальні інструменти взаємодії. Показано, що країни із жорсткішим інституційним поділом монетарних і фінансових цілей та інструментів і розвинутим фінансовим ринком досягають координації політики переважно застосовуючи ринкові механізми. Формальні механізми (інструменти) взаємодії потрібні й більш важливі для країн, які не мають достатньо глибокого фінансового ринку чи традиції його адекватного функціонування. Визначено, що у Чорногорії, яка обрала фінансовий режим євроізації, координація монетарної та фінансової політики є важливішою, ніж для країн із власною грошовою одиницею. Автором зроблено висновок, що, враховуючи брак досвіду використання ринкових механізмів взаємодії із фінансовим ринком, його недосконалість і обмежені можливості, у Чорногорії доцільно виробити формалізовані способи взаємодії монетарної та фінансової політики держави, щоб посилити їх координацію.

Ключові слова: монетарна політика; фінансова політика; координація; євроізація; державний борг; формальні механізми взаємодії; неформальні механізми взаємодії.

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АНАЛИЗ КООРДИНАЦИИ ФИСКАЛЬНОЙ И МОНЕТАРНОЙ ПОЛИТИКИ В ЧЕРНОГОРИИ

Аннотация. В статье обосновано, что для достижения целей экономической политики необходимо обеспечить высокий уровень гармонизации между монетарной и фискальной политикой государства и установить между ними адекватную координацию, используя как формальные, так и неформальные механизмы взаимодействия. Показано, что страны с более жестким институциональным разделением монетарных и фискальных целей и инструментов и развитым финансовым рынком достигают координации политики преимущественно с помощью рыночных механизмов. Формальные механизмы взаимодействия приемлемы в большей степени для стран, которые не имеют достаточно глубокого финансового рынка или традиций его адекватного функционирования. Определено, что в Черногории, которая избрала финансовый режим евроизации, координация монетарной и фискальной политики более важна, чем для стран с собственной денежной единицей. Автором сделан вывод о том, что, учитывая недостаток опыта использования рыночных механизмов взаимодействия с финансовым рынком, его несовершенство и ограниченные возможности, в Черногории целесообразно выработать формализованные способы взаимодействия монетарной и фискальной политики государства, чтобы усилить их координацию.

Ключевые слова: монетарная политика; фискальная политика; координация; евроизация; государственный долг; формальные механизмы взаимодействия; неформальные механизмы взаимодействия.

1. Introduction

From the formal point of view, Montenegro complies with a great number of recommendations in the choice of institutional answers aimed at the coordination of policies, i.e. the institutional and operative arrangements which the theory insists upon. However, when analyzing coordination in its true sense and considering that it has so far been used as an instrument for the encouragement of economic growth, as a policy stabilization instrument and as the means for management of the public debt, it can be irrefutably concluded that it is necessary

to improve the whole system of coordination of policies in Montenegro.

2. Brief Literature Review

Numerous studies point to the necessity of coordinating the monetary and fiscal policies in order to attain the desired goals of economic policy. Sargent and Wallace (1981) [1] and Woodford (1995) [2] deal with the monetary implications of fiscal indiscipline. Beetsma and Bovenberg (1999, 2001) [3, 4] examine the influence of the anti-inflationary oriented central banks on fiscal policy. A number of authors, such as Beetsma

and Uhlig (1999) [5], analyze the discretionary and rule-based policy. Costs, related to the unsynchronized monetary and fiscal policies, in different variations are examined by Anderson (2002) [6] and many others. Generally speaking, Semmler and Zhang (2004) [7] recognize four groups of studies devoted to the interaction of the monetary and the fiscal policy. The models used most often for showing the connections between the monetary and the fiscal policies were developed by Mundell (1962) [8], Krugman (1979) [9], Barro and Gordon (1983) [10], Nordhaus (1994) [11], IMF (2003) [12] and others.

Barro (1997) [13] and Evans (1985) [14] emphasize that the budget deficit and public debt have no significant impact on the movement of nominal and real interest rates. Other authors demonstrate the importance of the public debt structure for the implementation of the objectives of monetary and fiscal policies in the short and the long term (Cosimano and Gapen, 2003) [15].

Laurens and Piedra (1998) [16] identified the necessary arrangements for the successful coordination of monetary and fiscal policies. Hanif and Farooq (2008) [17] emphasize the importance of establishing formal or informal coordination committees or groups for the coordination of monetary policy and public debt management policy, usually composed of key decision makers in the ministries of finance and the central banks. The establishment of such bodies, which can actually have different forms and organizational structures, is aimed at providing a mechanism for the consideration of various strategies that would contribute to achieving the objectives of the monetary and the public debt management policies (Sehovic, 2013, p. 21) [18].

3. Purpose

This work aims to analyze the coordination between fiscal and monetary policies in Montenegro since the introduction of euroisation in 2002; verify the adequacy of coordination in terms of the institutional and operational arrangements fulfillment on which theory insists upon; examine the performance of coordination as an instrument for the economic growth promotion and a tool of stabilization policy; test the adequacy of the existing coordination of monetary policy and public debt management policy; as well as to point out the possible matters which could be improved in the coming period through coordination.

4. Results

Taking into account a range of institutional and operational arrangements which are insisted upon in the relevant theoretical studies, we come to the conclusion that Montenegro, in the formal sense, complies with a good part of the recommendations in the selection of institutional arrangements for policy coordination.

Both in the normative sense and through the Constitution, the Central Bank of Montenegro has been recognized as an independent institution. The area related to the manner of treating the central bank profits or losses has also been normatively regulated. The law mandates the information exchange between monetary and fiscal authorities, as well as the prohibition of crediting or guaranteeing loans to government or state institutions. A number of mechanisms for information exchange between monetary and fiscal authorities have been defined. Fiscal rules have been defined by law. A coordinating body was also established, in the form of the Financial Stability Council.

Arrangements for coordination between the fiscal and monetary policies in Montenegro are implemented through: The Financial Stability Council; the Central Bank recommendations for the implementation of economic policy; the Central Bank Opinions to the Parliament of Montenegro, regarding certain draft laws; Ad hoc work groups formed by the representatives of the monetary and fiscal authorities; Direct communication between the Central Bank and the Ministry of Finance (Zugic & Fabris, 2013, pp. 53-64) [19].

The most important arrangement for the coordination of fiscal and monetary policies in Montenegro is certainly the Financial Stability Council. The Council is an efficient mechanism for monitoring, identifying, preventing and mitigating potential systemic risk in the financial system of Montenegro, with the aim of preserving the financial stability of the system and influencing factors that could endanger it (Official Gazette of the Republic of Montenegro, 2010a) [20]. This ensures coordination

among the economic policy-makers, especially between the fiscal and monetary policies.

The following arrangement used to achieve coordination between the two policies is the legal obligation of the Central Bank of Montenegro to conduct regular macroeconomic analysis and to make recommendations to the Government of Montenegro to conduct the economic policy in the coming year. In addition, coordination of monetary and fiscal policies in Montenegro is partially achieved also through the Central Bank's opinions on drafts of laws, which influence the goals for whose achievement the Bank is responsible. The Central Bank also issues opinions on the Debt Management Strategy, adopted by the Government with the opinion of the Central Bank. Coordination is achieved also through the ad hoc work groups formed by the representatives of monetary and fiscal policies. These occasional technical bodies are formed in order to solve certain issues which may appear in the Montenegrin economic system. Finally, the direct communication between the representatives of the monetary and the fiscal authorities also represents an important contribution to a more successful policy coordination, because decisions of great importance for the future directions of economic policy to be implemented in the following periods are based precisely on such direct communication.

When talking about coordination as an instrument for the encouragement of economic growth and the instrument for the fiscal policy of stabilization, it is important to emphasize that in the pre-crisis period it had been found lacking, especially in individual cases.

In terms of the euroized economy, fiscal policy is practically the only relevant instrument for conducting the stabilization policy. In the years before the crisis, fiscal policy holders implemented an expansionary fiscal policy, in order to stimulate expenditure and economic growth. In the period from 2002 to 2011, fiscal policy had a significant element of pro-cyclicality, because it did not restrain but encouraged the business cycle. Experience from 2007 and 2008, when an obvious inflationary growth, significantly higher than normal, was evident in Montenegro, shows that in this period fiscal policy, in individual cases (the growth of gross income by as much as 30%), had the character of an expansive rather than a restrictive one (Sehovic, 2014, p. 339) [21]. This is the best example of inadequate coordination between the two policies. Chart 1 shows the orientation of fiscal policy in Montenegro in the period from 2002 to 2012.

Starting from 2009, there was a strong contraction of economic activity, with an increase in illiquidity and the spillover of the negative effects of the crisis affecting the region, as well as the weakening of potential for recovery and of the development drivers, which all resulted in a drastic reduction in aggregate demand. Aware that the basic prerequisite for the growth of the Montenegrin economy is the fiscal or financial stability, and thus fiscal consolidation, coordination of the fiscal and monetary policies in Montenegro gained particular importance in this period.

Consequently, a series of measures were undertaken in the domain of fiscal policy aimed at improving the quality of public finances. Therefore, fiscal policy which was conducted since 2009 has a conservative character. Despite the numerous constraints it faced due to the accepted monetary regime, monetary

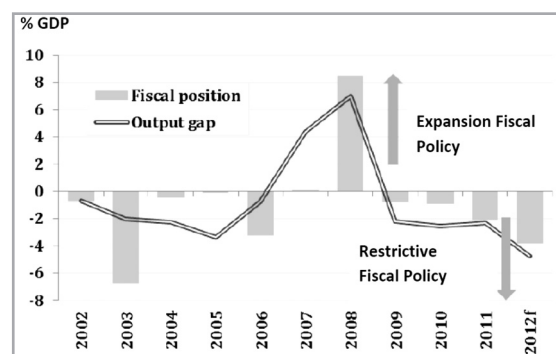


Chart 1: Orientation of the fiscal policy in Montenegro in 2002-2012

Source: The World Bank, 2012, p. 36 [22]

policy in Montenegro was also directed towards the preservation of monetary and financial stability of the state, which is actually its best contribution to fostering economic growth at the moment. In this regard, in the confrontation with the negative consequences of the crisis, the emphasis was placed on maintaining the liquidity of the banking system and the prevention of the deposits outflow. Coordination with the fiscal policy and with the Ministry of Finance in particular came to the fore in the late 2008 during a joint drafting of the Law on Measures for the Protection of the Banking System (Official Gazette of Montenegro, 2008) [23], which was in force until the end of 2009, and which identified the measures for the conservation of liquidity and solvency of the banks that are established and operating in Montenegro. This prevented a more pronounced outflow of deposits and the collapse of the Montenegrin banking system.

A prerequisite for a successful coordination between the monetary and fiscal policies is the coordination of the objectives, instruments and operational arrangements between the monetary policy and the public debt management policy. Coordination of goals, instruments, institutional and operational arrangements of the monetary policy and the public debt management policy is not only important for avoiding potential conflicts of jurisdiction, but also because its joint action, information exchange and technical cooperation can accelerate the process of market building, expand the room for maneuver of the fiscal and monetary policies, encourage savings and, finally, as a general result – support the macroeconomic stability of the country in question (Babic, Bubas, & Svaljek, 2001, pp. 1-97) [24].

In fact, in order to successfully carry out the coordination of instruments and measures of monetary policy and public debt management policy, the literature dealing with this issue points to the necessity to not only apply the adequate institutional and operational arrangements, i.e. the selection of the location of functions for the management of public debt (the Ministry of Finance, the Central Bank, a special institution for the management of public debt), but also to fulfill a few basic prerequisites, which include: development of the market of securities issued by the government; independence of the central bank; transparency of public debt management.

Since the transparency and predictability of public debt management policy depends on the development of the securities market, this is an important prerequisite for successful coordination. Given that in Montenegro this market segment is essentially undeveloped, the benefits mentioned above are also absent due to the small number of financial instruments and the dominance of banks. This is also the reason why it is important to insist on the conclusion of formal arrangements for joint action of the Ministry of Finance and the Central Bank of Montenegro, which is the recommendation in the case of the failure to meet this pre-requirement.

The other prerequisite for a successful coordination is fulfilled in the formal sense, considering that the Constitution of Montenegro guarantees the independence of the Central Bank. In brief, the Central Bank can achieve a good and effective coordination with the policy of public debt management only as an independent entity. In the contrary case, it would not represent coordination but the subjugation of the Central Bank to the fiscal policy holders.

The transparency of public debt management in general comes down to the drafting of the Debt Management Strategy, which contains the objectives and instruments of public debt management which consequently become available to the public and contribute to the previously mentioned transparency. This prerequisite is in principle fulfilled in Montenegro, because there is a legal obligation mandating the preparation of this Strategy.

On the other hand, when there is a mismatch between public expenditure and public revenue, and when public expenditure cannot be financed

from the regular public revenue, there is an accumulation of debt. If this growth in public spending is not accompanied by abundant tax revenue, this leads to the formation of the budget deficit, whose financing often requires additional borrowing. The economic theory of the connection between the mentioned concepts is represented by the following equality (Lojschova, Rodrigues-Vives, & Slavik, 2011) [25]:

$$\frac{Debt(t) - Debt(t-1)}{GDP(t)} = \frac{Public\ expenditure(t) - Public\ revenue(t)}{GDP(t)} + \frac{Deficit\ debt\ adjustment}{GDP(t)}$$

Economic theory defines the debt sustainability criterion through the equation:

$$s \geq (r - g) * d,$$

where s – primary budget balance; r – real yield on the long-term state bonds; g – real GDP growth rate; d – debt-to-GDP ratio.

Based at this equation, Chart 2 shows the scenario of debt sustainability in Montenegro.

The fact that high indebtedness together with the openness of our economy causes its overexposure to external shocks, the development potential of Montenegro is significantly limited, and therefore a key objective in the public finances must be their stabilization and consolidation (Sehovic, 2014, p. 336) [21].

When it comes to recommendations for a more successful coordination in the coming period, one of the most important is the need for a better operational harmonization, and the removal of elements of pro-cyclicality which arose as a result of the mutually incompatible directions of fiscal and monetary policies in Montenegro – certainly pronounced in the previous pre-crisis period, and which later resulted in the faster deterioration of fiscal indicators. Therefore, coordination between policies aimed at reaching countercyclical effects emerges as a necessity.

Namely, in the situation when the Montenegrin economy showed signs of overheating, due to the surprisingly high inflow of foreign investments (40% of GDP in 2007) and the external crediting by the domestic banking sector (loans granted for the economy grew at a rate of 180% per annum at the end of 2007), fiscal and monetary policies were not sufficiently synchronized. At the end of 2007, the government decided to increase the public sector salaries by 30%, which together with a 10% increase in the minimum wage, represents a typical pro-cyclical measure. The lack of coordination with the monetary policy became evident when shortly thereafter the Central Bank was forced by an administrative measure to limit credit growth, which at the end of 2007 was at the level of 180%, in order to reduce the previously mentioned overheating effect. Such lack of coordination, which caused the pro-cyclical effect, had an extremely negative impact on the later macroeconomic trends, and starting immediately from 2008 onwards. In addition, the importance of good coordination is more and more prominent because of the euroized regime implemented in Montenegro, and the fact that coordination in such a regime is even more important. Therefore, the coordination between fiscal and monetary policies aimed at achieving the effects of countercyclical macroeconomic stability in Montenegro is crucial.

A step towards a better coordination of policies is also represented by the use of open market operations. The Law on the Central Bank has opened the possibility that the Central Bank,

| Parameters | | 2013 | 2014 | 2015 | 2016 |
|--------------------------------------|---|--------------------------------|--------------------------------|--------------------------------|--------------------------------|
| s | Primary budget balance, in % of GDP | -4,4 | 0,17 | -4,64 | -4,08 |
| r | Real yield on the long-term state bonds, in % | 5,56 | 5,56 | 5,56 | 5,56 |
| g | Real GDP growth rate, in % | 3,3 | 2,5 | 3,5 | 3,8 |
| d | Debt-to-GDP ratio, in % | 57,95 | 58,8 | 60,3 | 62,3 |
| $s \geq (r - g) d$ | | -4,4 ≥ 1,3 | 0,17 ≥ 1,79 | -4,64 ≥ 1,24 | -4,08 ≥ 1,09 |
| | | High burden on public finances | High burden on public finances | High burden on public finances | High burden on public finances |

Chart 2: Debt Sustainability in Montenegro
Source: Author's analysis, Sehovic (2014a, p. 335) [21]

in the implementation of monetary policy, may operate in the financial markets through the purchase, sale and exchange of securities and other readily marketable financial instruments, and through buying and selling of precious metals, i.e. that it may perform operations on the open market.

The next area for improving coordination of fiscal and monetary policies in Montenegro is in the area of government debt, which has already reached a critical level for an economic system such as Montenegro. In this sense, it is necessary to influence the increase of transparency of the fiscal policy and the debt management policy in Montenegro, even though it has been improved after starting with the practice of drafting the Debt Management Strategy. A step in this direction is also the recent adoption of the Law on Budget and Fiscal Responsibility, which stipulates that the Fiscal Strategy, as an umbrella document adopted for the duration of the mandate of the Government, and therefore covers also the Fiscal Policy Guidelines and the Debt Management Strategy, is adopted in the parliamentary procedure which guarantees full transparency and public involvement.

Increasing transparency would significantly contribute to the definition of the appropriate role of the Parliament of Montenegro in the process of deciding on the content of the Strategy, by finding a mechanism to consult the Parliament in the course of its preparation. Of course, it would be necessary to provide appropriate treatment of the opinions on the draft of the Strategy, which according to the Law on Budget and Fiscal Responsibility, are submitted by the Central Bank. Inclusion of the Parliament, together with an adequate treatment of the Central Bank's opinion on the Strategy draft, would contribute to the improvement of coordination of the two policies.

The coordination between fiscal (the debt management policy) and the monetary policy would definitely help define the obligation of preparing the Annual Report on the Management of the Public Debt, which would be open to the public after the approval by the Government. In this way, the public would regularly receive information on the debt policy, while one part of the Report would have to be devoted to cooperation with the Central Bank during the development of the Strategy.

Formal respect of the obligation of the timely exchange of information regarding state revenues and expenditures and on the borrowing plans between the Ministry of Finance and the Central Bank, would also contribute not only to improving coordination, but ultimately also to the increase the liquidity of the financial system, as well as the harmonization of instruments used by the policies' holders.

The following recommendation for improving coordination could be linked to the need to establish a practice of organizing formal or informal meetings between public debt managers from the Ministry of Finance and the relevant representatives of the Central Bank. The aim of organizing such meetings would be to find a mechanism to discuss the practical aspects of implementation of guidelines or policies which had been previously agreed upon in the Strategy. On the other hand, due to the insufficient development of the market of securities issued by the government, which is one of the basic prerequisites for successful coordination, it is necessary to establish formal provisions concerning coordination and the joint action of the Central Bank and the Ministry of Finance.

It appears that it is also necessary to adequately treat the obligation to respect more the objectives and guidelines set forth in the Debt Management Strategy. This is due to the fact that in the previous period, since the beginning of the obligation to draft these strategies, this had sometimes not been case, which is just one of the many issues that worsened the fiscal parameters related to public debt.

Taking into account the increased importance of coordination of the fiscal and monetary policies in Montenegro caused by the application of the euroisation regime, and the fact that a key challenge for our public finances is a better management of public debt in function of its future reduction, useful imposed and the eventual establishment of the coordination committees or a coordination group for the above mentioned policy, formally or informally constituted and assembled by the Ministry of

Finance and the Central Bank for dealing with the tasks related to public debt management.

One of the prerequisites of successful coordination of the monetary and the public debt management policy is certainly independence of the Central Bank. Independence is partly the result of the treatment of income/loss with which the Bank is faced. The legal definition of the profit and loss treatment helps increase the independence of the Central Bank of Montenegro.

5. Conclusions

Montenegro formally meets the greatest part of the recommendations in terms of institutional and operational arrangements necessary for coordination, insisted upon by the relevant studies. However, the coordination of fiscal and monetary policy (liquidity policy) in Montenegro needs to be further improved, despite some positive steps made in recent years. It is necessary to achieve a better operational coherence, in terms of removing elements of pro-cyclicality in the performance of policies; creation of favorable conditions for the possible use of open market operations; improvement of the public debt management by a more transparent adoption of the Debt Management Strategy and the Annual Report on Debt Management; the establishment of the practice of organizing formal or informal meetings between public debt managers in the Ministry of Finance and the relevant representatives of the Central Bank; the establishment of formal provisions concerning the coordination and joint action of the Central Bank and the Ministry of Finance; securing a greater respect of the objectives and guidelines set forth in the Debt Management Strategy; the appointment of coordinating committees for the needs of coordination of the aforementioned policies; and the improvement of the profit (loss) treatment of the Central Bank.

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