

Final GDN/CERGE-EI RRC12+50 Report
Project Title: “Fiscal and Monetary Policy Interactions in the South Eastern European Economies with Fixed Exchange Rate Regime”

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NON-TECHNICAL SUMMARY

Since the very beginning of the transformation process, the former communist countries have declared their aspiration towards joining the European Union (EU). In this respect, they have engaged in massive institutional and economic reforms which have helped them to converge gradually to the "old" EU members. As a result, first Bulgaria and Romania and later on Croatia succeeded in achieving the goal of EU accession, while Macedonia has been given the candidate status. Looking forward, SEE countries are faced with another challenge related to the EU accession process, namely, that of adopting the single currency.

Therefore, exploring the transmission of EU economic and policy shocks represents a relevant research issue for the former transition economies from SEE, such as: Croatia, Macedonia, and Bulgaria. The paper aims to examine the following issues: What is the reaction of fiscal and monetary policy in SEE countries to a shock in the economic activity within the EU? What is the reaction of fiscal and monetary policy in SEE countries to a shock in the EU inflation rate? Do monetary policies in SEE countries follow the monetary policy implemented by the European Central Bank? In addition, we seek to find out whether there are any significant differences in the impacts of foreign shocks on domestic macroeconomic variables depending on the level of EU integration. Hence, the paper provides empirical evidence on the effects of several euro-zone macroeconomic and policy shocks (output gap, inflation, and interest rates) on several macroeconomic and policy variables in the SEE countries (output, inflation, interest rates and

budget surpluses) based on the impulse response functions estimated with recursive VARs. In this way, we are able to assess how the exogenous factors affect macroeconomic performances and policy variables in SEE economies.

Generally, the estimated results imply that euro-zone economic activity has significant and relatively strong influence on SEE economies and these external shocks are transmitted relatively quickly. Moreover, the results also suggest that if the domestic economy is more integrated with the EU, then these exogenous shocks are more persistent. An additional finding is that shocks in the foreign reference rate are relatively quickly transmitted to domestic money market rates. We can explain these effects by several factors, such as: the fixed exchange rates, the relatively high integration of SEE financial markets to EU financial markets as well as the dependence of banks on foreign financing. Surprisingly, euro-zone inflation does not have a significant influence on domestic inflation, which might indicate that inflation in SEE economies is mostly driven by idiosyncratic shocks.