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IMPLICATIONS OF LOW INFLATION IN MONTENEGRO

This paper examines negative repercussions of low inflation in Montenegro in terms of monetary strategies of its fixed exchange rate regime. It starts from the hypothesis that low inflation causes many economic problems, creating a boomerang effect. Conclusion is that under conditions of underdeveloped institutional and microeconomic environment, long-term low inflation can contribute to macroeconomic stability. Regardless of the existing monetary-exchange rate regime, destructive implications of the financial crisis and psychological factors had negative impact on the sustainability of low inflation environment.

Keywords: inflation; deflation; monetary policy; exchange rate regime; macroeconomic policy.

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МОЖЛИВІ НАСЛІДКИ НИЗЬКОЇ ІНФЛЯЦІЇ В ЧОРНОГОРІЇ

У статті описано можливі негативні наслідки низької інфляції в Чорногорії в контексті актуальних монетарних стратегій країни та фіксованого валютного курсу. Висунуто гіпотезу про те, що низька інфляція призводить до значних економічних проблем і може мати «ефект бумерангу». Покроково доведено, що в умовах нерозвинутого інституційного та мікроекономічного середовища тривала низька інфляція сприяє макроекономічній стабільності. В той же час, деструктивні наслідки фінансової кризи та низька психологічних факторів чинять негативний вплив на стійкість низькоінфляційної середи.

Ключові слова: інфляція; дефляція; монетарна політика; режим валютного курсу; макроекономічна політика.

Табл. 1. Літ. 14.

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ВОЗМОЖНЫЕ ПОСЛЕДСТВИЯ НИЗКОЙ ИНФЛЯЦИИ В ЧЕРНОГОРИИ

В статье описаны возможные негативные последствия низкой инфляции в Черногории в контексте актуальных монетарных стратегий страны и фиксированного валютного курса. Выдвинута гипотеза о том, что низкая инфляция приводит к значительным экономическим проблемам и может иметь «эффект бумеранга». Пошагово доказано, что в условиях неразвитой институциональной и микроэкономической среды длительная низкая инфляция способствует макроэкономической стабильности. Но в то же время, деструктивные последствия финансового кризиса и ряд психологических факторов имеют негативное влияние на устойчивость низкоинфляционной среды.

Ключевые слова: инфляция; дефляция; монетарная политика; режим валютного курса; макроэкономическая политика.

Introduction. The strategic choice of a monetary policy implies an adequate choice of nominal anchor, i.e. publicized nominal variable, which serves as a target. Nominal anchor promotes price stability influencing the value of money and reducing inflationary expectations. Consistent monetary strategy helps stabilize inflation expectations at the desired level. The choice of optimal strategy, which may incorporate the elements of different approaches, mainly depends on specific circumstances of individual countries: size, foreign trade relations, financial structure etc. There is a

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consensus among economists that the determination of sustainable (trend) inflation rate is the only long and profound influence that monetary authority can have on the economy.

Montenegro has opted the exchange rate targeting. Some countries from the same region have chosen the policy of inflation targeting, which implies greater focus on the dynamics of domestic aggregate demand (in relation to the restriction of money supply) and prefers rationale in relation to adaptive inflationary expectations. Euroization, as a strategy of monetary policy in Montenegro, is based on the regime of pegged (fixed) exchange rates. This strategy implies the absence of monetary policy and exchange rate policy.

After high inflation rates, recorded in the first years of the post-conflict period, until the dissolution of the Federal Republic of Yugoslavia, inflation in Montenegro was high. In the period 2001–2006, inflation rate decreased from 28% to 2.9%. In the period after 2006 it dropped from 2.9% to 0.7% (Table 1).

Table 1. Inflation rates in Montenegro, 2006–2014, %
(Statisticki godisnjak 2006–2014, www.monstat.org)

Years	2006	2007	2008	2009	2010	2011	2012	2013	2014
Inflation rate	2.9	4.3	8.8	3.5	0.7	3.5	4.1	2.2	-0.7

The presented statistical framework does not represent a solid basis for reaching final conclusions about low inflation effects. Statistics does not indicate any satisfactory effects of economic environment and implementation of economic politics. Numerous analyses and studies failed to sufficiently analyze the relevant factors that the determine relation between low inflationary environment and economic social problems: the decline of living standards, the persistence on destructive economic models (quasi-neoliberal type), irrational behavior of state regulation institutions, exponential growth of debt, growing poverty, low coverage of imports by exports, uncollectibility of bank loans, low consumption, drop in investments etc.

The most widespread and the simplest measurement of inflation is CPI. But the problem with it is methodological inconsistency, diversity and wrong choice of consumer basket, and probably the susceptibility to political influence on shaping the actual indicators. V. Draskovic (2008: 498) points out that Montenegrin statistics is still in its infancy and does not provide reliable information on personal and investment spending, some aspects of trade offer, sectoral growth rates etc.

Theoretical approach: academic and ideological profile of inflation definition. In an effort to define and "justify" inflation, economists have emphasized its causes or consequences. Complexity and heterogeneity of inflation enables its precise definition. I. Perisin (1985) has emphasized the consequences, defining inflation as a process of self-supported and differently caused price increases, which gradually, sooner or later, after the advancing stimulating effects of rising prices, leads to declining of living standards for most people, the exhaustion of national sources of foreign exchange, deterioration of foreign exchange balance and the exchange rate of national currency and disordered market. All this in continuity impeding the functioning of economy, causing new disruption in distribution system and economy.

Citizens Economic Thought has offered its interpretation of inflation causes, based on excessive demand (demand pull of inflation). Inflation theory of demand

(monetary inflation or purchasing power inflation) starts from the hypothesis that excessive aggregate of monetary demand in relation to commodity funds leads to prices increase. The problem arises with inadequate action of the monetary system, which creates too much unconvertible money, thus increasing prices. Specific causes of inflation are: covering budget deficit through government borrowing from central bank, credit expansion over the available savings level, unblocking the part of monetary volume and activating the hoarded money, rapid increase in nominal national income and inflationary gap.

According to "monetarist version", inflation is always and everywhere a monetary phenomenon, which occurs through faster growth of money quantity, than the growth rate of production. Thus, the quantity of money in circulation is in direct relation to the general price level. The essence of inflation, consists in overcoming demand over supply.

The essence of Keynesian (income) approach to inflation of demand (inflationary pressures) is to overcome the corresponding commodity funds at the market, using any form of spending. Measures of monetary and fiscal policy are recommended for repressing inflation. In the middle of the last century there was an opinion that inflation always comes from increasing costs of production factors, especially wages. In the context of the inflation costs theory prices rise (cost push inflation). J.M. Keynes rejected the classical curb inflation and recommended active economic policy in order to strengthen the effective demand. According to him, prices are the function of inclination towards liquidity (and interest). Discrepancy between investment and savings is the main cause of inflation, where interest rate plays the main role. In case of insufficient propensity to consumption, the interest rate is very high, and a tendency towards liquidity is excessive. Monetary policy should strengthened the first and weaken the second and the third. J.M. Keynes was the proponent of a mild inflation, with the emphasis on psychological factors as primary ones, while the importance of monetary factors is not decisive. In a state of full employment, new issue of money leads to rising prices. The interest rate affects the cost, without intermediation in the quantity of money. The increase in production costs is the initial factor of increased inflation.

In terms of class theory on the causes of inflation, O. Eickstein (1981) pointed out the primary importance of core inflation, which depends on wage trends and capital costs. Shock inflation is caused by changes in specific prices (oil, agricultural products). Demand inflation is determined by the degree of capacity utilization and unemployment. Similarly, anti-inflation measure is proposed as price control by the government. The problematic nature of these theories comes from the fact that increase in production factors costs is the cause of inflation, providing that it is accompanied by an increase in the quantity of money in circulation. Also, monetary policy is primarily focused on the regulation of aggregate demand, not production costs.

The main cause of contemporary inflation C. Levinson (1974) sought in the orientation of multinational companies on their own fund sources for the purposes of financing the active role of capital in new investments. By increasing prices, companies increase the overall accumulation and become the bearers of inflation. He particularly emphasized the dominance of American capital in multinational companies.

By focusing attention on relations in production, he tried to prove that changing the position of employees in funds disposition and profits distribution should contribute to lower inflationary pressures and stable development. C. Levinson has pointed to stagflation as the coexistence of inflation and high unemployment. Thereby, he points to the limited impact of monetary and fiscal policies that are inefficient as anti-inflationary instruments. In his opinion, inflation in capitalist countries was the result of economic and political influence on prices formation, i.e. the relation between big capital and state authorities.

According to many authors, employees' demands for wage increase is a result of the increased living costs. New economic conditions imposed the simultaneous action of inflation and high unemployment. This was contrary to the generally accepted theory that mild inflation reflects positively on economic development, i.e. that employment growth can be achieved by accepting inflation. C. Levinson (1974) rejected the correlation between the growth of nominal wages and unemployment (Phillips curve). That correlation emphasized the false dilemma: commitment to higher inflation rate or to lower rate of employment.

After the 1970–1980s, when inflation was the biggest enemy, came the period of sustained fall in the aggregate price level (deflation). Contrary to the conventional view, historically speaking, deflation has often been associated with strong economic growth and satisfactory productivity ("good deflation"). Also, a drop in prices did not always characterize the phases of recession. Relatively recent experiences suggests that deflation is more of a symptom rather than the underlying cause of economic hardship, i.e. stable and moderate deflation does not result in deflationary spiral. Considering that rapid growth of monetary aggregates in the end transformed into inflation, traditional monetarist approach to solving the problem of deflation is cited as an important option for central banks in underdeveloped countries. The drop of oil prices further makes the deflation realistic.

L. Ball (1999) and L. Svensson (2000) explained how standard small open-economy inflation targeting models embody a central role for the exchange rate in the transmission from monetary policy to inflation. Typology of possible alternative monetary policy responses to targeting was presented by L. Leiderman, R. Maino and E. Parrado (2006: 5).

Inflation in the context of fixed exchange rate regime – the example of Montenegro. Dilemmas of strategic choice, transmission mechanism and adequacy of instrumentarium are the focus of theoretical and empirical analysis of monetary policy. The exchange rate regime does not impact fully numerous positive and negative characteristics of the observed state in economy. Consistent strategy helps stabilize inflation expectations to the desired level. The question is: how much reduction of inflation can bring macroeconomic benefits, by jeopardizing economic growth and significantly weakening fiscal balance at the same time, amid further social repercussions?

At the initial stage of euroisation in Montenegro (since 2002), the economy was characterized by slump inflation: the rate of economic growth was 1% and below, with the inflation above 10%. It enabled more funds in the hands of the state and "entrepreneurs", while population was forced to accept reduced participation in their distribution. The behavior of privileged social groups, big companies, monopolies and

associations were the decisive factor in price trends, as well as decision making of state bodies. Due to increased confidence in euroisation, after hyper-inflation and other market distortions, the remonetization process was surging. The share of money supply in GDP was growing. The rate of inflation, measured by the retail price index, significantly reduced. Inflation was usually the result of cost and structural (imported) inflation (CBM, 2010). Adequate reaction was achieved through restrictive fiscal (discretionary) policy, which limited the aggregate demand as a generator of counter-cyclical effect. Demand inflation began in 2007, and fiscal policy had required counter-cyclical character. That is why Montenegro suffered one of the sharpest deterioration of the current account worldwide.

The cost of losing flexible monetary and exchange rate policy is still present. The crisis has indicated that the loss of the said flexibility was not offset by long-term benefits of low inflation, convertibility and stable currency. The share of money supply in GDP increased after the introduction of euroisation. In the period of 2003–2007, share of M2 in GDP increased 4 times. The Central Bank in its official publications after 2007 did not disclose the height of monetary aggregates. Typical was the inflexibility of prices downwards with inadequate resilience of international capital flow in relation to interest rates. Due to the lack of surplus in payment balance, the amount of money was small, so high interest rates and GDP level were adapted. This has threatened the liquidity of economy and budget. The consequence for the economic system is the increase in government debt (30.06.2015) to the level of 2.16 bln EUR, which is 60.3% of GDP (Statisticki godisnjak 2015, www.monstat.org).

In this low-inflationary setting, already fragile institutions of the system were destroyed. During the crisis and practically deflationary scenario a bubble of bad (non-performing) loans at the level of around 1 bln EUR (with interest) was created. Bank placements were significantly reduced. The lending interest rates were unjustifiably high, and the passive ones were unacceptably low. Under the conditions of low inflation in the euroized regime, interest rates should be much lower, and the role of monetary authorities should be proactive. This protectionist approach to the whole economic system have effected public finance (budget), the financial system, all industries and external economic relations.

The benefits of low inflation should have been reflected in terminating the redistribution of national wealth, which naturally occurs under inflation. Montenegrin reality points to structural poverty and key redistribution in favor of those who made their fortune during the wave of hyperinflation (the 1990s) and "privatization" (the 2000s). Unemployment is the most realistic indicator: about 180,000 working age people are not employed and do not have income, household debt is over 1 bln EUR. Under the current socioeconomic circumstances there is almost no chance to exit the spiral: devastated economy – unemployment – indebtedness – poverty – lack of perspective. On the other hand, low, stable and sustainable inflation has preserved and multiplied the assets value of "financially sophisticated" subjects and strengthened the pseudo-elite status for less than 5% of population.

Privatized companies have exhausted public finance and reduced unemployment. The deficit of significant investment does not enable the employment growth. Average and minimum wages are low, and huge percentage of population is at the poverty level or below. Taxation of labor is significant, while corporate tax rates are

low. The share of public spending in GDP is high, as current expenditure, which prevents institutional participation in regulating the economy. There is no active and integrative industrial policy. A large number of budget users by the total number of employees is discouraging. The vast majority of youth is at risk of economic and social exclusion, with potentially serious consequences of demographic and social nature.

Continuous set of economic problems has become long-term due to: a) long and uncertain duration of negative trends in the economy; b) the inability to solve all economic problems using monetary and fiscal policies; c) crucial reliance on capital flows, specifically on foreign direct investment, determined by selective political decisions; d) destructive relation with key institutions of the economic system; e) problematic foundations, efficiency and sustainability of "solutions", such as fiscal consolidation, financial liberalization, macroeconomic stabilization, the abolition of business barriers etc.

Conclusion. The aim of low inflation should correspond with the absence of major macroeconomic disturbances. This goal is set in accordance with the assumption that by 2016 structural reforms and prices liberalization will not be completed, nor institutional and structural convergence towards the European Union. Our analysis clearly shows that low long-term inflation does not lead to satisfactory economic results in Montenegro. On the contrary, maintaining inflation at a low level has led to many economic and social consequences. The following stands out: the low level of GDP along with its extremely slow growth, high external and internal indebtedness, economic uncompetitiveness, high unemployment, rate unsatisfactory level of economic freedom, high barriers in business and significant economic control by powerful networks.

Intensified effects of psychological factors are not measurable, but they realistically predict future problems in functioning of the whole economic system. The focus remains on expectations, forecasts, reducing the tendency to consume and increasing migrations to Western Europe.

Inflationary-deflationary environment in Montenegro has been influenced by internal and external factors. Although, it is not possible to precisely define their actual relationship, we can identify 3 significant factors of influence: the dominant political and geopolitical influence on economic trends and performance in a long period, particular interests based on criminogenic (primarily corruptive) forms of operating and paternalistic attitude of international financing institutions.

In Montenegro, realistically there are many potential sources of inflation. They are generated in various deficits, economic and structural disproportions, monopolies and other negative economic phenomena. Without recovery in foreseeable future, Montenegro will face intensified inflation and further crisis development. Possible price increases for food and energy would automatically affect the development of inflationary spiral. Besides must not neglect the poor methodology of calculating inflation by official national statistical authorities (Monstat).

Adaptive effects of macroeconomic policy are weak, because of pretentiously and unduly emphasizing the role of monetary policy in creating economic growth. This bypasses the objective institutional responsibility for creation and implementation of the overall macroeconomic policy, which currently has intolerable quasi-neoliberal character.

In addition to poor domestic demand and problems with foreign demand, low inflation has indirectly affected (through the reduction of economic activity) the creation of chronic problems in the banking system. This is primarily related to the overload of non-performing loans and high interest rates followed by strong competition in banking environment. When foreign direct investments are reduced, the growth in money supply is slow. That was temporarily maintained by the additional borrowing. In such a situation, relatively high imports present an extremely dangerous exhaust valve for balancing the aggregate demand, and thus provoking an outbreak of inflation and economic bankruptcy. Dominant borrowing and policy of banks' required reserves are the proof of limited effects on fixing the exchange rate and the existence of inconsistent development strategy and corresponding quasi-neoliberal economic policy.

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