Monetary Policy and Catching up in CESEE Region

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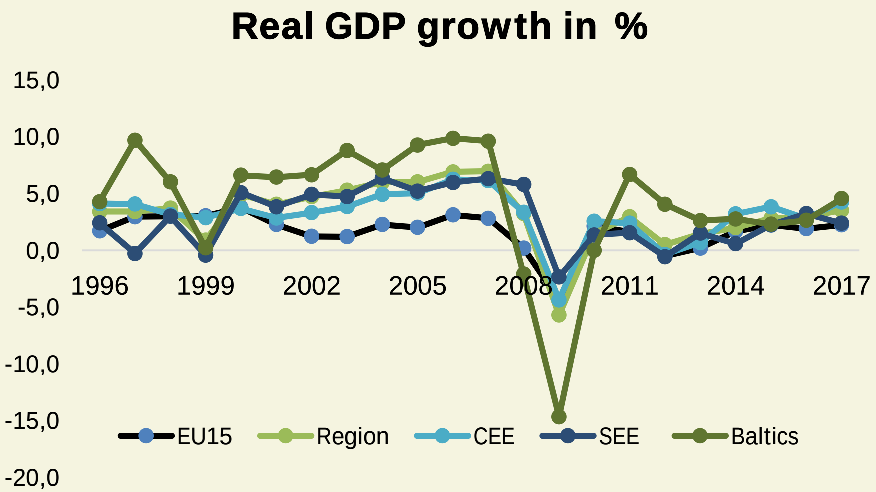
Key issues on CESEE real convergence

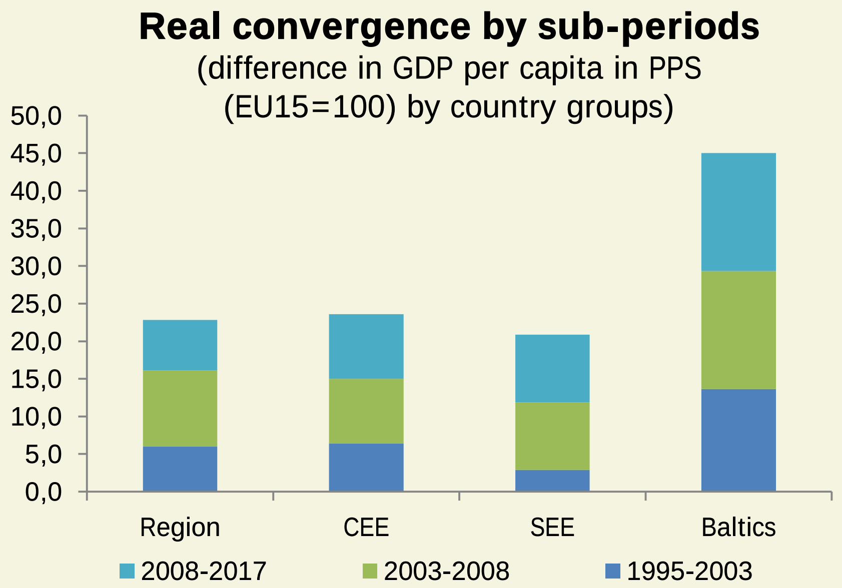
- **Stock-taking of the real convergence features and dynamics in CESEE region, as one of the dimensions of broader economic convergence:**
  - Why after solid income convergence in the pre-crisis period, convergence decelerated in the post-crisis period?
  - What have been the driving factors, was it the increase in institutions and economic structures or favorable financial cycle? What changed after the emergence of crisis?
  - “Durable” or “temporary” convergence?
  - What has been the role of the monetary policy?

- **The current state of play in terms of real convergence and challenges ahead:**
  - How to get back on fast-track convergence?
  - What is the monetary policy room to further underpin this process?
  - Role of structural and institutional reforms to accelerate and assure sustainable catching–up process.

Real Convergence in CESEE before the Crisis Durable or Temporary?

- Strong growth leading to rapid convergence across all sub regions (strongest in Baltics)
- Almost half of the post-transition convergence occurred within 2003-2008 period (two thirds in the Baltics)...
- ...on the backdrop of remarkably growth conducive global surrounding, favourable EU prospects, and reform processes, as well...
- .....that spurred capital inflows and enhanced financial deepening...
- ...while strong credit growth underpinned strong demand and overall higher GDP growth in comparison with advanced Europe...
- but seems **temporary**, not durable

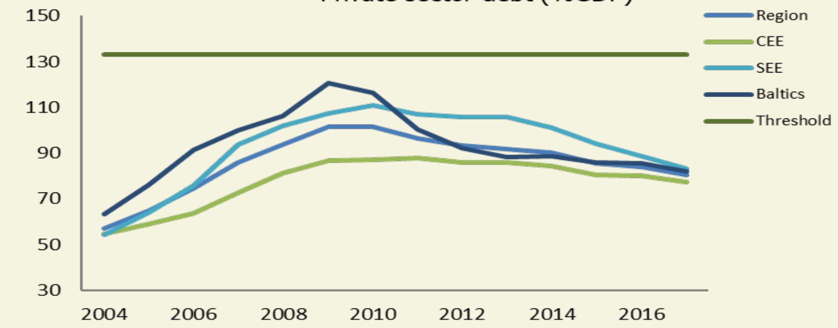




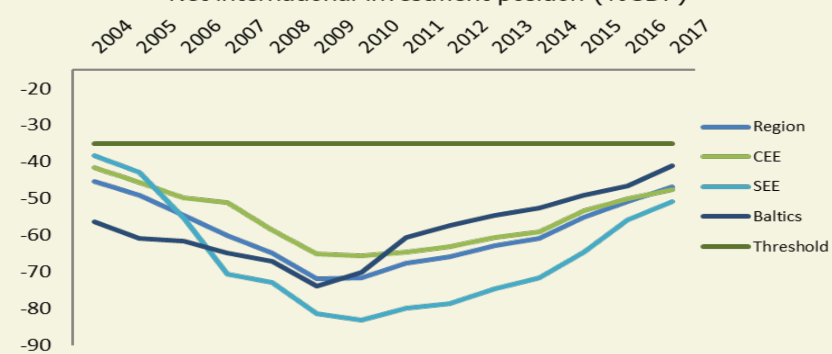
Real Convergence in CESEE before the Crisis Accompanied with rising vulnerabilities

- CESEE would have been expected to have much higher rates of capital accumulation than what they actually had....
- ....but capital inflows and credit growth failed in providing sustainable **competitiveness convergence** (with flows channelled to less efficient sectors of the economy)...
- ....all off this led to **rising domestic and external vulnerabilities**-increased private sector debt that underpinned import growth and resulted in higher CAD, as well as in increased overall IIP
- Credit-boom driven growth in some countries led to **overestimation of potential growth and procyclical domestic policies** that also added to the creation of vulnerabilities.
- Financial crisis put a halt on growth and convergence, and some economies faced "painful“ adjustment

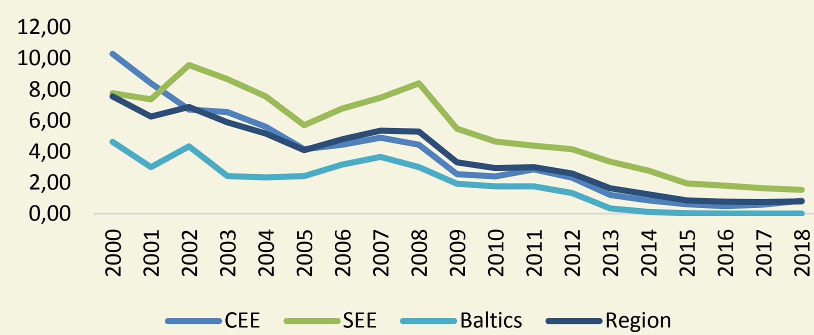
Private sector debt (%GDP)



Net international investment position (%GDP)

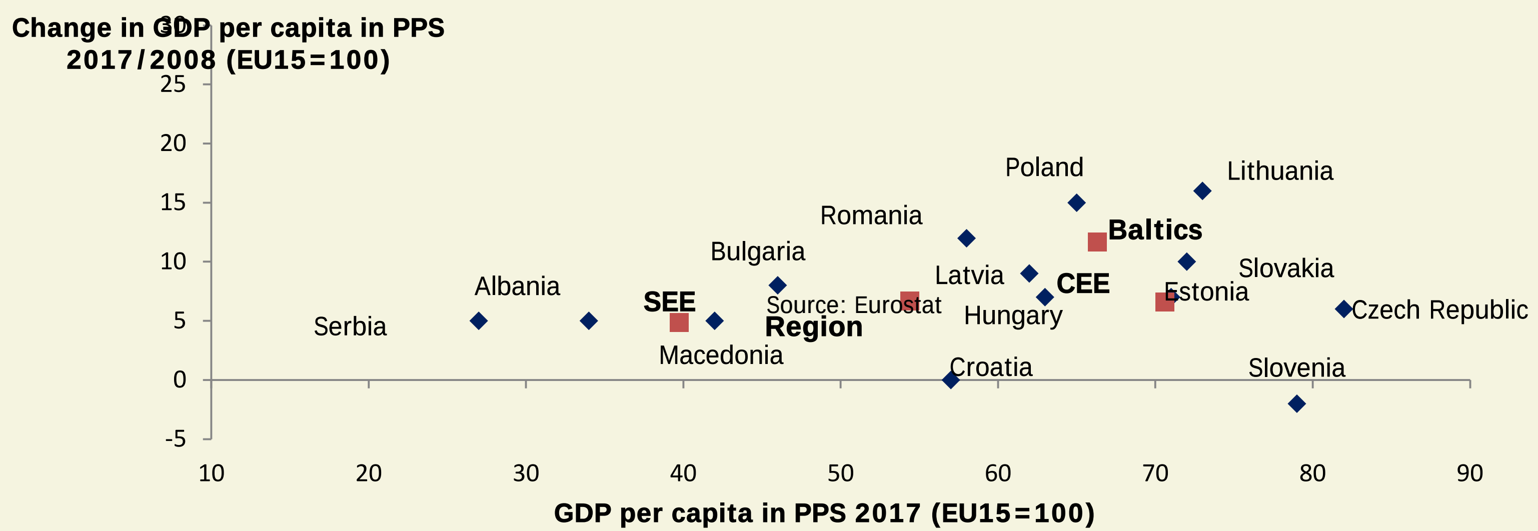


Central bank interest rates, in %



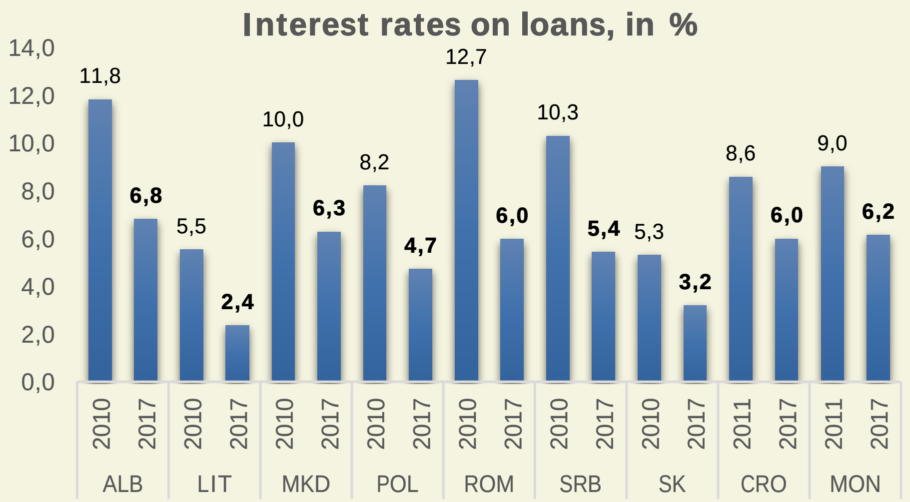
At current growth rates, convergence seems off fast track

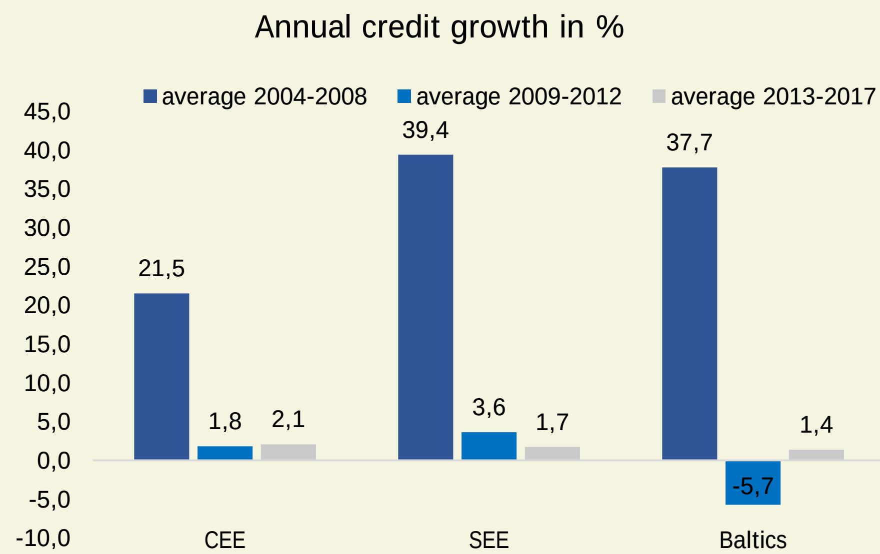
- **With the growth pick-up, real convergence continued since 2010, but at a notably slower pace** (about 6 p.p. of GDP in comparison to 12 p.p. of GDP)
- **SEE countries**, which are bellow or close to 50% convergence level, in particular slowly advanced
- **Some countries even reverted** from the convergence path being growth-constrained by mounted vulnerabilities
- Currently, **income gap still remains wide** at about 54% of EU-15



Role of the monetary policy
Growth and convergence conducive in the post-crisis period...

- Ultra loose monetary policy across the board - growth supportive environment
- Reduction of policy rates and unconventional policies have contributed to lower costs of financing (reaching historically low rates)...
- ...but time needed for confidence recovering and reducing certain structural impediments for faster credit growth (mounted NPLs or repairment of balance sheets, for instance)
- Credit growth increased in the recent period, reaching 3.4% in 2017, on average, for the region

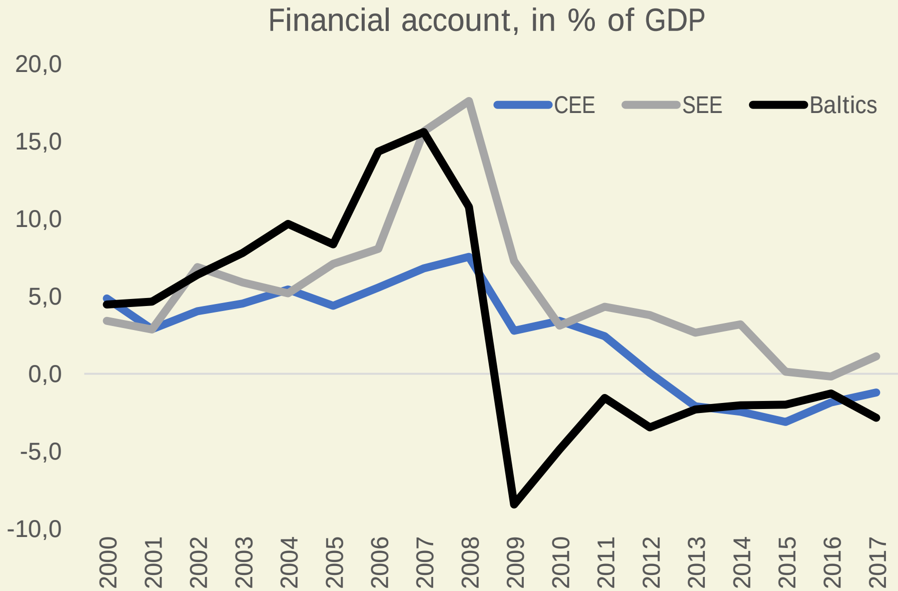




Source: Central banks' websites of selected countries and NBRM staff calculations.

...consistent with the ECB policy accommodation

- The ECB interest rate adjustment created room for policy rate reduction in the region...
- ...while the quantitative easing policy provided liquidity, supportive for capital inflows, although at a decelerated pace almost across all countries and all types of financial flows (FDI, portfolio, loans)...
- ...banking systems faced deleveraging, and non-financial corporate sector decelerated inflows, while in government sector intensified inflows were seen, reflecting expansionary fiscal policy



Source: IMF.

Limits of the Monetary Policy

- **Despite unprecedented monetary accommodation**, growth in the region not strong enough for fast track convergence

- **With the on-going normalization of monetary policy of the FED and ECB**, the room for further accommodation is lesser

- **The remaining public and private sector debt vulnerabilities** require cautiousness in the further risk-taking - the expected interest rates pick-up accentuates the matter

- **Monetary policy needs to assure stability** by providing stable macroeconomic conditions, anchoring expectations and contribute to prevention of build–up of vulnerabilities...

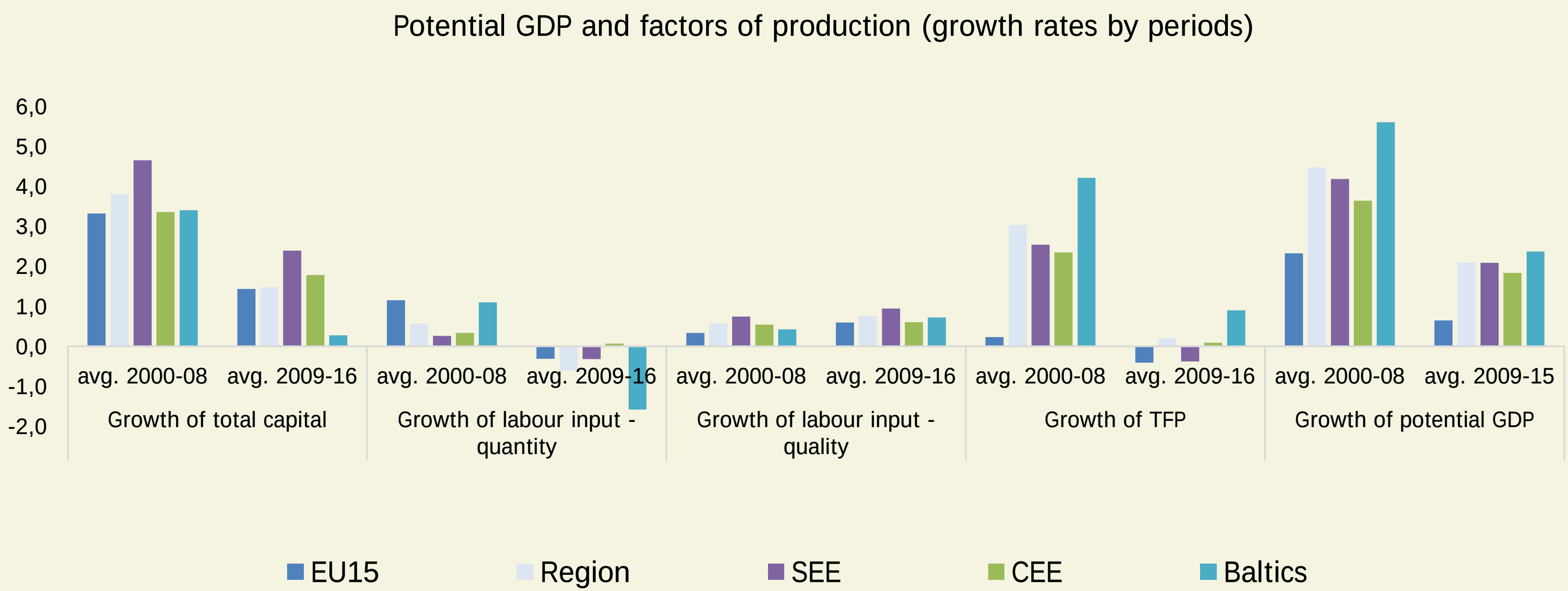
- **...and it can not be a substitute for deeper structural**, institutional and fiscal reforms, needed for opening the virtuous cycle of growth and “sustainable” convergence

- ...**while structural reforms will not only lift the long-term potential** and strengthen fundamentals, but also reduce risk premium and allow slower pace of MP normalization, and thus help dealing with remaining vulnerabilities

- ...and **be conducive to higher synchronization of economic structures** thus being beneficial in dealing with the potential shocks

Refocusing on structural and institutional policies

- Slower growth reflects cyclical, but also structural issues as visible through lower potential growth (broadly half of the pre-crisis)
- Need for addressing deep-seated structural and institutional issues



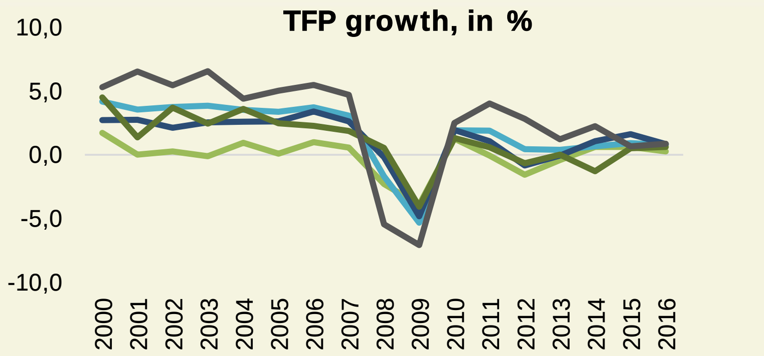
Source: Conference Board Total Economy Database: Growth accounting and Total factor productivity and World Bank.

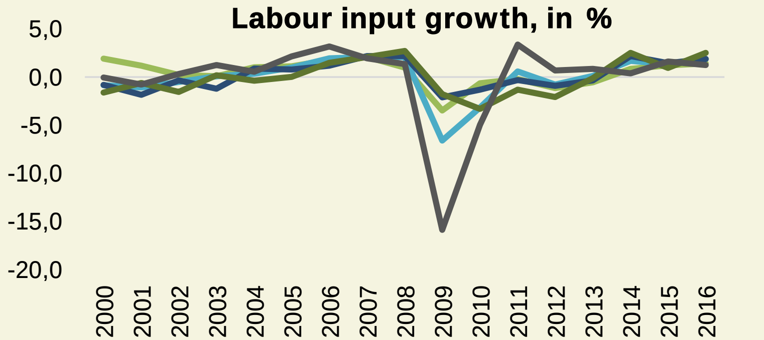
Lower potential growth reflects lower growth of all determinants of production

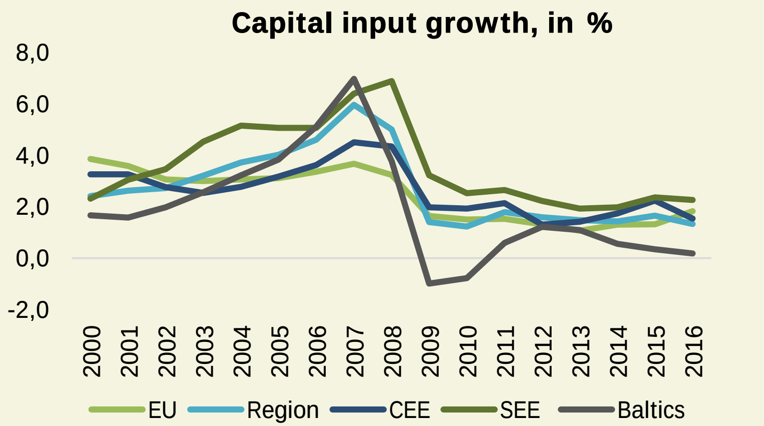
- **TFP** - slower structural reforms, absence of pre-crisis external tailwinds (strong trade, GVCs, abundant capital inflows);

- **Labor** - slow employment growth or shrinking working age population and emigration;

- **Capital** - lower savings/investments

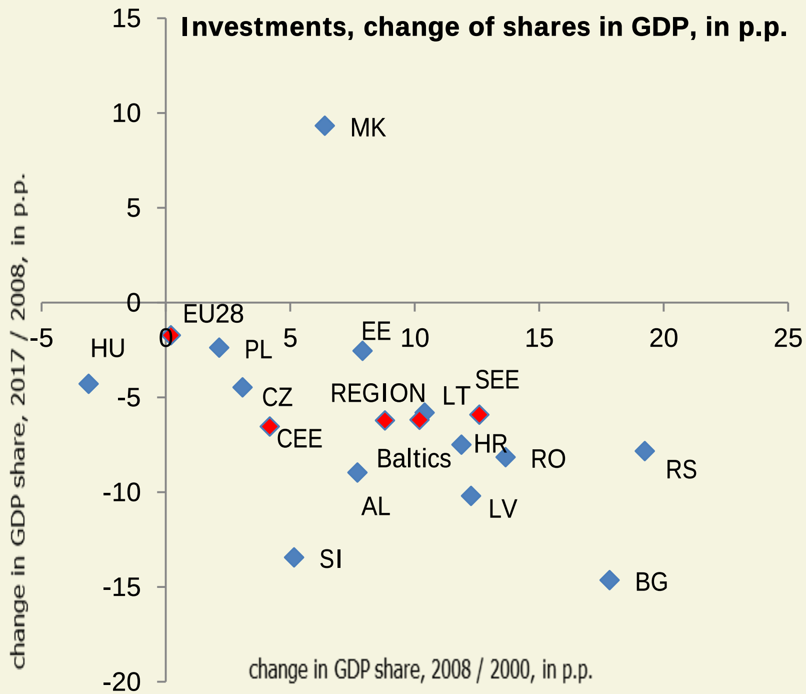


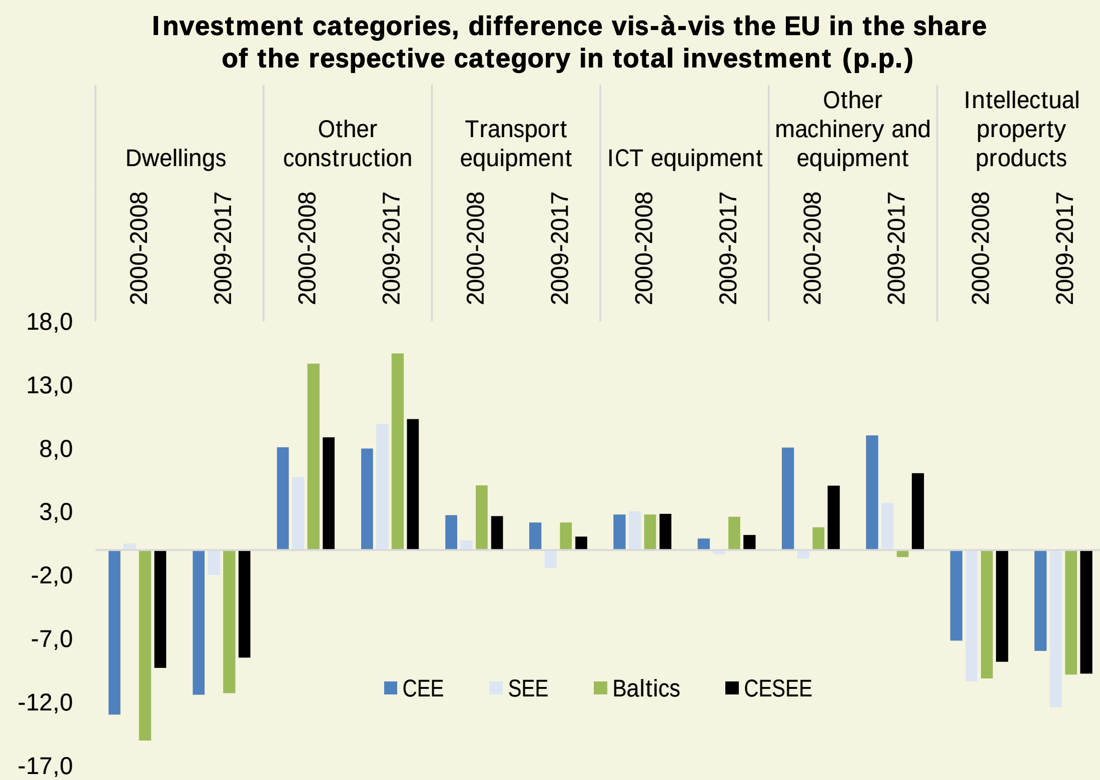




Urgency for boosting investment growth

- **Investments significantly lower in comparison with the pre-crisis period**, but also below estimated benchmarks for fast convergence past episodes
- Especially low in segments of intellectual property products/R&D/intangible assets
- **Reflecting set of factors** (lower inflows, lower domestic savings, narrower borrowing space, lower return on investments)

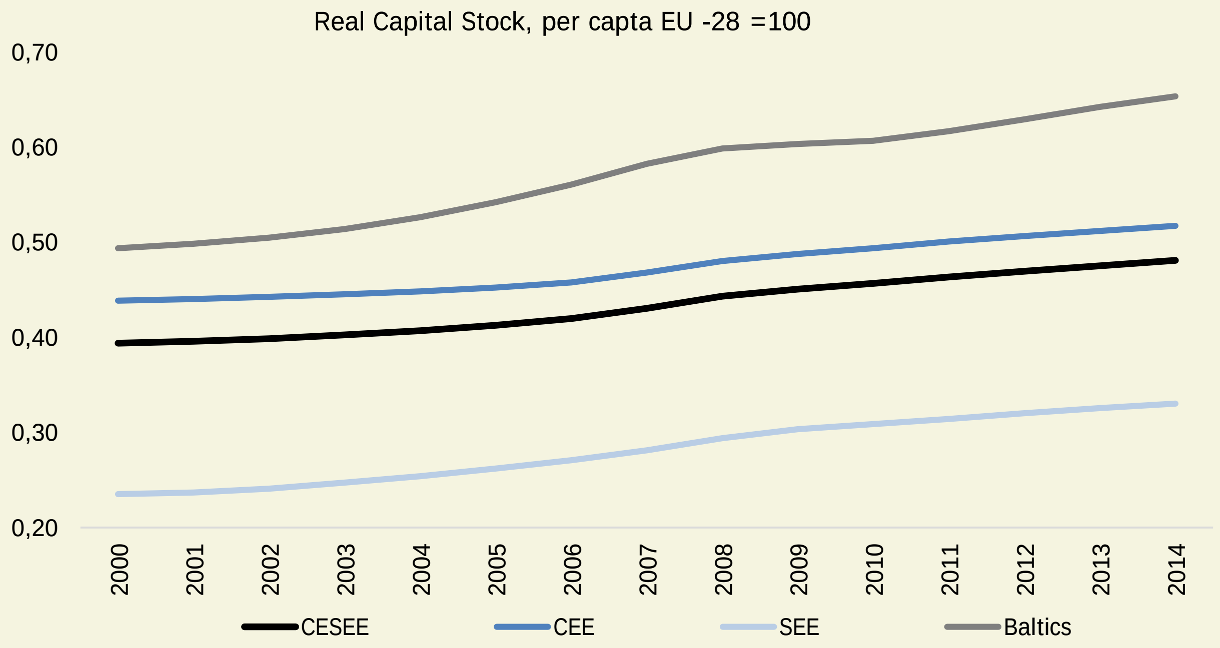




Source: Eurostat, IMF and NBRM staff calculations.

Gaps in capital stock visible

- **Existent gaps in capital stock** – a sign for the need for stronger investment growth



Source: Penn World Tables and NBRM staff calculations.

Saving rate for investment support (1)

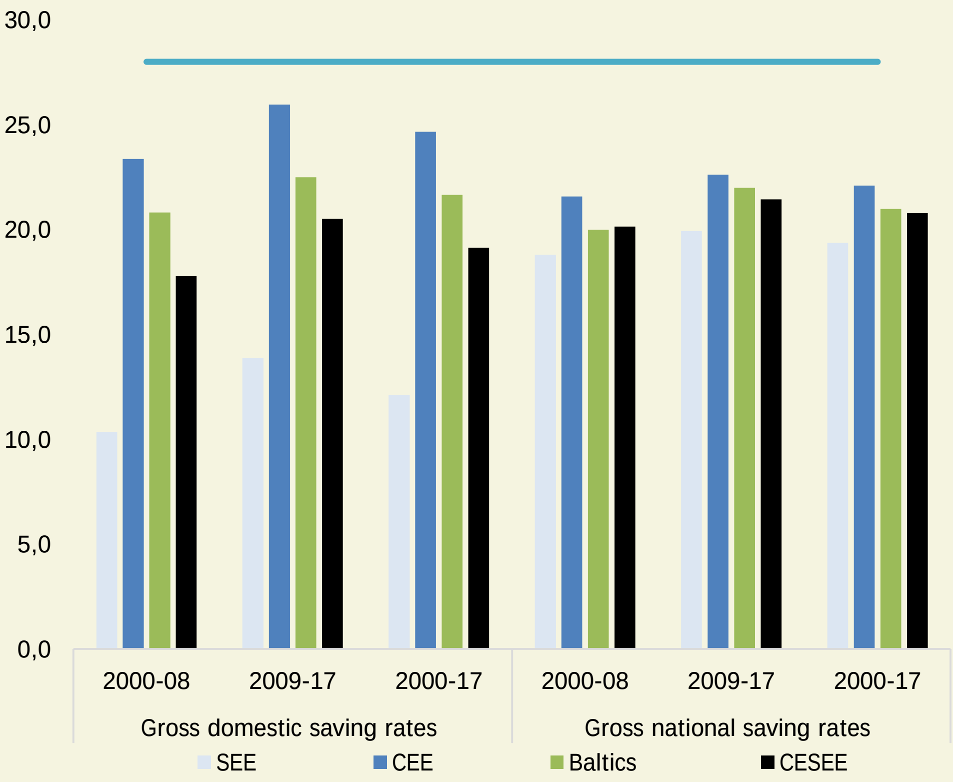
- **Need for higher saving rates in the region**

- Enhanced incentives for the **corporate sector** to reinvest earnings, rather than distributing dividends

- Support **household savings** by putting stronger emphasis on Pilar II and III pension schemes, supply of new instruments and financial education

- **Disincentives for saving in cash:** FX cash holdings in the region are still very high - potential for increase of banks' deposit base, greater intermediation and higher investment support

National and domestic saving rates, averages for 2000-2017 period (%GDP)

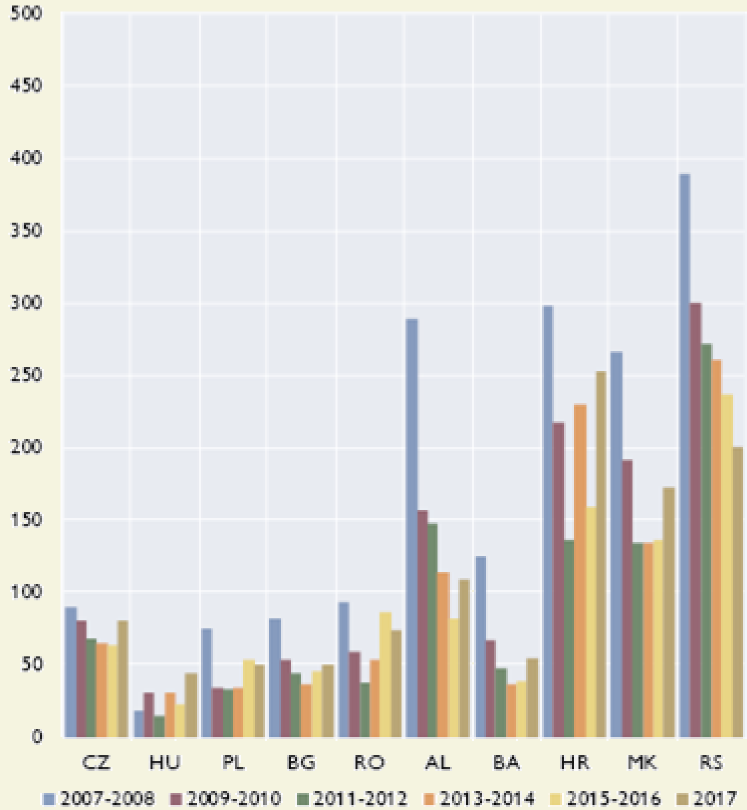


Source: Eurostat and NBRM staff calculations. The benchmark denotes a level of saving/investment rate that is consistent with fast-track convergence (Regional Economic Issues 2015-2016, Central, Eastern, and Southeastern - Europe How to Get Back on the Fast Track, May 2016)

Saving rate for investment support (2)

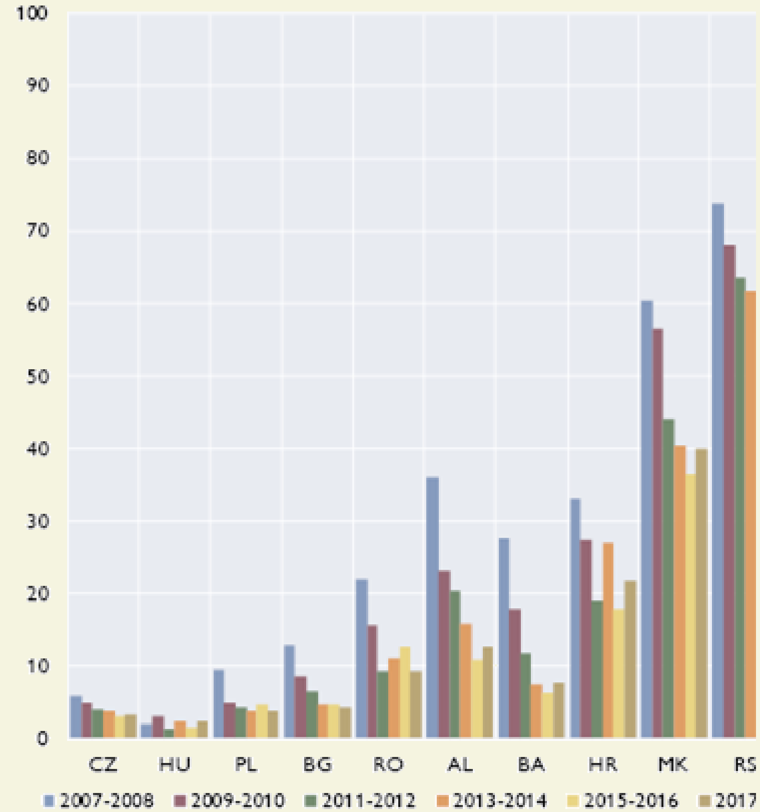
Amounts of euro cash holdings by individuals

EUR, per capita (projection)



Currency substitution index

%



Source: OeNB Euro Survey.

Note: Per capita values are extrapolated for the entire population aged 14 years and over. Currency substitution index = ratio of euro cash to euro cash plus national currency in circulati
See Scheiber, T.& Stix, H. 2009. OeNB Working Paper 159.

Changes on institutional and structural front for productivity catch - up

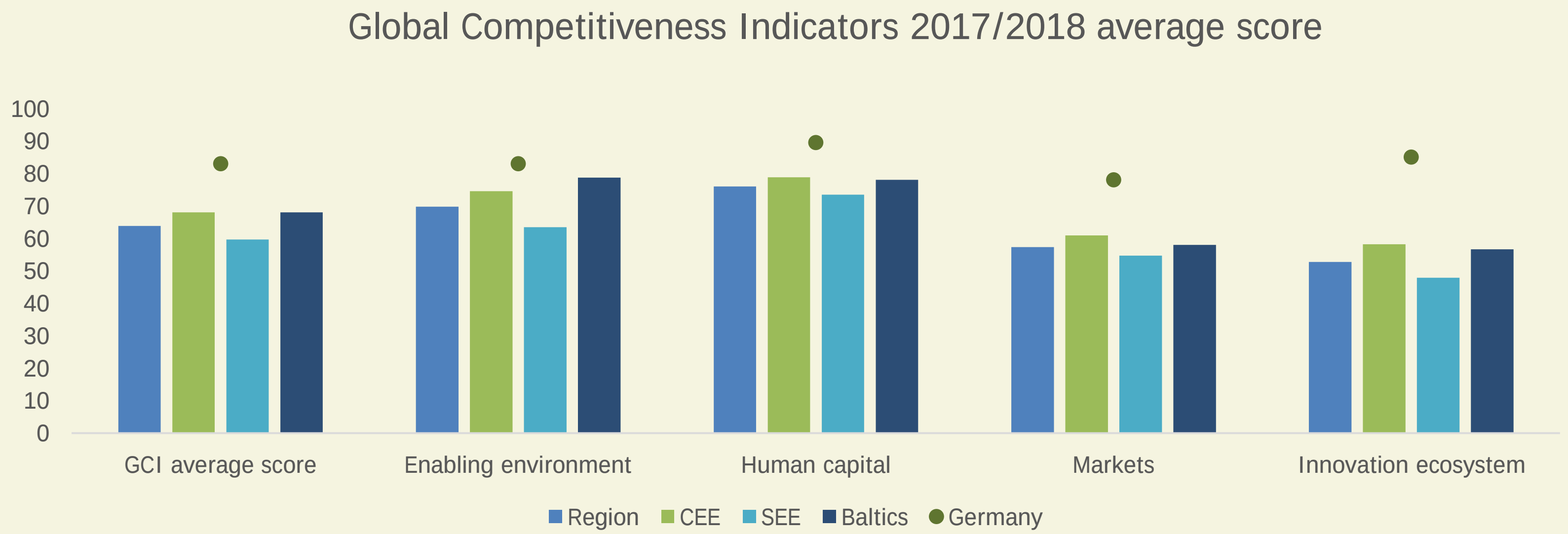
- Structural and institutional reforms could bring significant **productivity** gains
- **The heat map of scores of the latest GCI** reveals a space for convergence in many areas (**institutions, infrastructure, skills and innovations, in particular**)...
- ...it also reveals differences among country groups, with Baltic countries leading on the reform stage, while SEE countries lagging behind in many areas.

		Institutions	Infrastructure	ICT adoption	Health	Skills	Business dynamism	Innovation capability
CEE	Czech Republic	60	84	66	88	74	70	57
	Hungary	54	78	61	81	68	57	48
	Poland	57	79	54	86	73	61	49
	Slovakia	56	78	68	84	69	65	47
	Slovenia	63	77	66	92	73	70	58
SEE	Bulgaria	54	70	70	80	65	60	44
	Croatia	52	77	60	86	63	56	38
	Romania	58	71	67	80	62	60	40
	Serbia	52	73	57	81	68	61	40
	Albania	54	57	52	87	69	64	32
	Bosnia	46	61	46	85	58	53	28
	Montenegro	55	62	57	85	68	63	35
	Macedonia	51	64	54	80	59	61	31
Baltic	Estonia	70	75	77	85	78	69	53
	Latvia	58	73	80	79	74	64	42
	Lithuania	61	75	76	79	73	65	47
CESEE		**56.3**	**72.1**	**63.2**	**83.6**	**68.4**	**62.4**	**43.1**
EU15		**69.9**	**85.1**	**69.9**	**95.5**	**78.5**	**72.3**	**70.5**

Heat map of scores from selected pillars from the GCI 4.0 index (lighter color indicates better performance).
Source: World Economic Forum, Global competitiveness report 2017-2018 and NBRM staff calculations.

Are productivity and competitiveness challenges same across the board?

- The distance to the benchmark country largest in the innovation pillar for all country groups
- Baltic countries with the lowest gap compared to Germany in all areas, followed by CEE economies
- SEE group with scores bellow the regional average, and with the largest gap to Germany



Source: World Economic Forum, Global competitiveness report, 2017-2018

Conclusion

- **The region made tremendous progress** in the real convergence process in the last 25 years on the backdrop of set of factors (reforms that led to more efficient use of resources, conducive global environment and favorable EU prospects)

- **Large part of the convergence occurred before the global crisis**, and the process slowed markedly afterwards, despite the unprecedented monetary stimulus

- **Further convergence challenging at the current juncture** of slow pace of implementation of reforms, less supportive external environment and gradual normalization of monetary policy

- **To get back on fast track convergence-** address longstanding structural issues that will enhance economic structure and institutional quality thus lifting potential and reducing vulnerabilities

Thank you for your attention