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.
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 below 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

![Graph showing GDP per capita and change in GDP per capita in PPS from 2008 to 2017 for various countries.](image-url)
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
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.
• **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

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

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 circulation.
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.

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Heat map of scores from selected pillars from the GCI 4.0 index (lighter color indicates better performance).
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 below the regional average, and with the largest gap to Germany

Global Competitiveness Indicators 2017/2018 average score

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