“A Central Bank’s dilemmas during highly uncertain times”

Talking Points of Daniel Daianu, Member of the Board of the National Bank of Romania --Conference of the OENB, Vienna, 24 November, 2014

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Contents

- Preliminary remarks
- Where does the Romanian economy come from?
- Dilemmas of older vintage
- A new age, new dilemmas
1. Preliminary remarks

- A change of paradigm
- Breakdown of models
- Banking (finance) reform
- What central banks are supposed to do
- The fear of secular stagnation
- EU crisis
- An age of uncertainty
2. Romania: huge correction of imbalances

- A liquidity squeeze during 2008/2009, like other NMSs (high external deficits; big private borrowing); IMF and EU assistance for EU member states with different ER arrangements

- Massive correction of external deficits: the current account deficit went down to 0.8% of GDP in 2013 (from a double digit level during 2007-2008); the role played by markets’ freeze and upsurge of exports

- Massive correction of fiscal imbalance during 2010-2013; the role of agreements with the EC and IFIs

- Inflation at 1.6% at the end of 2013; in 2014 inflation is likely to be nearby

- Economic growth is forecast at cca. 2.5% in 2014 (from 3.5% in 2013, which was influenced by agricultural output) and a similar figure in 2015

- Public debt trebled, buy it is stabilizing around 40% of GDP.

- Fed’s tapering of its stimulus finds Romania much better prepared than during 2008/2009 turbulences: correction of imbalances and “buffers”
Romanian economy: real GDP growth

Real GDP growth rates (% y/y)

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP RO</th>
<th>CEE</th>
<th>GDP EU28</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>8.1</td>
<td>6.5</td>
<td>3.4</td>
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<tr>
<td>2007</td>
<td>6.9</td>
<td>5.5</td>
<td>3.1</td>
</tr>
<tr>
<td>2008</td>
<td>8.5</td>
<td>2.6</td>
<td>0.5</td>
</tr>
<tr>
<td>2009</td>
<td>-7.1</td>
<td>-3.7</td>
<td>-4.4</td>
</tr>
<tr>
<td>2010</td>
<td>-0.8</td>
<td>4.7</td>
<td>2.1</td>
</tr>
<tr>
<td>2011</td>
<td>1.1</td>
<td>5.6</td>
<td>1.7</td>
</tr>
<tr>
<td>2012</td>
<td>0.6</td>
<td>1.4</td>
<td>-0.4</td>
</tr>
<tr>
<td>2013</td>
<td>3.5</td>
<td>2.9</td>
<td>0.0</td>
</tr>
<tr>
<td>2014F</td>
<td>2.0</td>
<td>2.6</td>
<td>1.3</td>
</tr>
<tr>
<td>2015F</td>
<td>2.4</td>
<td>2.8</td>
<td>1.5</td>
</tr>
</tbody>
</table>

CEE; RO; EU 28; Source: European Commission (AMECO), Own calculations (Bulgaria, Croatia, Hungary, Latvia, Lithuania, Former Yugoslav Republic of Macedonia, Montenegro, Poland, Romania, Serbia, Turkey)
ESA 2010 methodology
Romanian economy: fiscal consolidation

RO, EU 28 (Net lending (+) / borrowing (-)); RO (Structural budget balance)
Source: European Commission, Autumn forecast 2014; ESA 2010 methodology
Romanian economy: major correction of the current account deficit

The correction of the current account imbalance (% of GDP)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Romania</td>
<td>-13.4</td>
<td>-11.5</td>
<td>-4.5</td>
<td>-4.6</td>
<td>-4.6</td>
<td>-4.5</td>
<td>-0.8</td>
<td>-1.2</td>
<td>-1.4</td>
</tr>
<tr>
<td>Bulgaria</td>
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<td>-22.4</td>
<td>-8.6</td>
<td>-1.5</td>
<td>0.1</td>
<td>-0.8</td>
<td>2.6</td>
<td>2.1</td>
<td>2.3</td>
</tr>
<tr>
<td>Poland</td>
<td>-6.1</td>
<td>-6.5</td>
<td>-3.9</td>
<td>-5.0</td>
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<td>-3.5</td>
<td>-1.3</td>
<td>-2.0</td>
<td>-2.4</td>
</tr>
<tr>
<td>Hungary</td>
<td>-7.2</td>
<td>-7.0</td>
<td>-0.8</td>
<td>0.3</td>
<td>0.8</td>
<td>1.9</td>
<td>4.1</td>
<td>4.3</td>
<td>4.3</td>
</tr>
</tbody>
</table>

Source: Eurostat, European Commission, Autumn forecast 2014
BPM6 methodology: Romania, Poland (2011-2015), Hungary
GDP - ESA2010
Romanian economy: risk perception

Romania CDS – 5Y vs. USD

Source: Reuters Datastream
Disinflation in Romania

Source: National Institute of Statistics, NBR;

*CPI minus administered prices; **CORE1 minus volatile prices (vegetable, fruit, eggs, fuels)
***Industrial production price index
Romanian economy: public debt has been stabilizing at cca. 40 % of GDP

General government consolidated gross debt (% of GDP)

<table>
<thead>
<tr>
<th>Year</th>
<th>Romania</th>
<th>EU28</th>
<th>CEE</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>60.4</td>
<td>41.3</td>
<td>39.1</td>
</tr>
<tr>
<td>2007</td>
<td>57.8</td>
<td>39.1</td>
<td>35.1</td>
</tr>
<tr>
<td>2008</td>
<td>60.9</td>
<td>35.1</td>
<td>23.2</td>
</tr>
<tr>
<td>2009</td>
<td>72.9</td>
<td>29.9</td>
<td>23.2</td>
</tr>
<tr>
<td>2010</td>
<td>78.4</td>
<td>46.4</td>
<td>46.9</td>
</tr>
<tr>
<td>2011</td>
<td>81.3</td>
<td>46.9</td>
<td>44.7</td>
</tr>
<tr>
<td>2012</td>
<td>85.0</td>
<td>45.5</td>
<td>37.3</td>
</tr>
<tr>
<td>2013</td>
<td>87.1</td>
<td>46.1</td>
<td>37.9</td>
</tr>
<tr>
<td>2014F</td>
<td>88.1</td>
<td>44.8</td>
<td>39.4</td>
</tr>
<tr>
<td>2015F</td>
<td>88.3</td>
<td>44.6</td>
<td>40.4</td>
</tr>
</tbody>
</table>

CEE; RO; EU 28; Source: European Commission (AMECO), Own calculations (Bulgaria, Croatia, Hungary, Latvia, Lithuania, Former Yugoslav Republic of Macedonia, Montenegro, Poland, Romania, Serbia, Turkey)


ESA 2010 methodology (data for the EU28 is calculated on a non-consolidated basis)
Romanian economy: gross external debt at the low end in the region

Gross External Debt * (% of GDP)

<table>
<thead>
<tr>
<th>Year</th>
<th>Romania</th>
<th>Bulgaria</th>
<th>Czech Rep.</th>
<th>Hungary **</th>
<th>Poland</th>
<th>Slovacia</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>67.4</td>
<td>104.8</td>
<td>49.9</td>
<td>174.2</td>
<td>58.7</td>
<td>72.9</td>
</tr>
<tr>
<td>2010</td>
<td>73.8</td>
<td>100.7</td>
<td>54.7</td>
<td>162.1</td>
<td>65.9</td>
<td>74.3</td>
</tr>
<tr>
<td>2011</td>
<td>75.5</td>
<td>90.5</td>
<td>57.5</td>
<td>184.5</td>
<td>71.8</td>
<td>76.7</td>
</tr>
<tr>
<td>2012</td>
<td>74.2</td>
<td>92.1</td>
<td>60.2</td>
<td>160.5</td>
<td>70.1</td>
<td>74.9</td>
</tr>
<tr>
<td>2013</td>
<td>68.6</td>
<td>91.0</td>
<td>66.3</td>
<td>144.9</td>
<td>69.4</td>
<td>81.2</td>
</tr>
<tr>
<td>2014 Q2</td>
<td>63.9</td>
<td>89.9</td>
<td>68.2</td>
<td>148.6</td>
<td>69.8</td>
<td>87.3</td>
</tr>
</tbody>
</table>

Source: National Central Banks, Own calculations, ESA 2010 methodology
* Romania (2013-2014), Czech Republic, Hungary, Poland: According to BPM6 Methodology;
** including SPE's
Romanian economy, external debt: public vs. private sector

Source: National Central Banks, Own calculations, ESA 2010 methodology
Romania (2013-2014), Czech Republic, Hungary, Poland: According to BPM6 Methodology
Romanian economy, external debt: short-term vs. long-term debt

Source: National Central Banks, Own calculations, ESA 2010 methodology
Romania (2013-2014), Czech Republic, Hungary, Poland: According to BPM6 Methodology
3. Older vintage policy issues

- “Structural strain”: how to deal with massive resource misallocation (analogy with overburdened monetary policy during the current crisis)

- The persistence of high inflation (role of expectations, moral hazard, the exchange rate pass-through); the move to “inflation targeting” in 2005 (inflation expectations were deeply entrenched…)

- Pace of financial liberalization
3.1 Financial liberalization

- Financial (capital account) liberalization and the “Tosovsky dilemma”; an intense debate
- The EU rules of the game (the single market and KAL) have enhanced a boom and bust cycle (see graphs..): the impossible trinity (trilemma) is a “dilemma” (Helene Rey)
- The interplay between the global financial cycle and the European financial cycle + inadequate international arrangements
- NBR’s efforts to stem the skyrocketing pace of credits of little avail: euroization and parent funding...
3.1 Financial liberalization: the European financial cycle

- Boom and bust did occur in large parts of the EU (see graphics)
- The importance of private borrowing in judging resilience to shocks (BoP crises)
- Romania faced a liquidity crisis because of markets’ freeze: the role of EU/IMF financial support and the Vienna Initiative
- In CESEEs public debts and private debts are much lower than in most of the EU: is there a puzzle with credit? Deleveraging...
Economic growth and bank lending

Central West Europe (Belgium, Germany, France, Netherlands)

Sursa: Eurostat, European sector accounts (Central bank; other monetary financial institutions), own calculations
Economic growth and bank lending

South Europe (Spain, Portugal, Italy, Greece, Cyprus)

Sursa: Eurostat, European sector accounts (Central bank; other monetary financial institutions), own calculations
Economic growth and bank lending

Western Europe (Ireland, United Kingdom)

Sursa: Eurostat, European sector accounts (Central bank; other monetary financial institutions), own calculations
Economic growth and bank lending

Northern Europe (Finland, Sweden, Estonia, Latvia, Lithuania, Denmark)

*Sursa: Eurostat, European sector accounts (Central bank; other monetary financial institutions), own calculations*
Economic growth and bank lending

East Central Europe (Croatia, Hungary, Austria, Poland, Slovenia, Slovakia)

Sursa: Eurostat, European sector accounts (Central bank; other monetary financial institutions), own calculations
Economic growth and bank lending

Eastern Europe (Bulgaria, Romania)

Sursa: Eurostat, European sector accounts (Central bank; other monetary financial institutions), own calculations
3. Which type of inflation targeting?

- Macroeconomic policy in a small open economy
- The choice for a “light” (flexible) IT
- Managed floating (allowing the Ron to appreciate to 3.1/1 euro was suboptimal…)
- The euroization impact on MP: the balance-sheet (wealth) effect due to exchange rate dynamics
- NBR cannot be complacent about big exchange rate gyrations (inflation, financial stability (balance-sheet effect))
- Deleveraging and GDP dynamics
3. “Light” Inflation Targeting

- The transmission mechanism operates, though with difficulty (lending rates); credit supply and demand constraints are high (high indebtedness?): is creditless recovery possible?
- IT relies also on administrative tools (RR for both euro and Ron funds)
- Macroprudential tools: they operated during 2006–2008, but with little efficacy
3. “Light” Inflation targeting

- Disinflation has occurred, but with large deviations from target (due to various, mostly supply shocks); large negative GDP gap after the crisis hit has helped disinflation.
- Fiscal policy was pro-cyclical after 2009 due to the forex constraint and the big structural budget deficit. The Monetary Policy easing was restrained because of ER depreciation fear. Why GDP bounced back though?
- Export dynamics were key in recent years; REERs and productivity gains.
3. Real IRs, REERs, GDP dynamics...

Source: National Institute of Statistics, NBR; REER – European Central Bank
3. A key trade-off

- The stimulus entailed by a less tight MP is counteracted by the wealth effect induced by an exchange rate depreciation (inflation and the balance-sheet impact)
- The impact of monetary conditions
- When the transmission mechanism breaks down lower policy rates are less effective (credit demand and supply constraints)
4. Recent vintage dilemmas: a new age?

- An age of uncertainty
- A paradigm shift (price stability is not sufficient for economic stability)
- Finance as an in-built destabilizer: the trilemma “is a dilemma, stupid”
- A breakdown of models: how to model non-linearities (tail events)
- Proliferation of extreme (tail) events/shocks
- Complexity on the rise and inability to understand it frequently
- An over-burdening of central banks’ functions
- Central banks can no longer rely on simple rules
- Prospects of much lower growth in the industrialized world (a balance-sheet recession, SecStag, very time consuming in its healing)
- Social and political implications of economic slowdown/recession
- Ineffective international policy coordination
- A decline in robustness and resilience
4. Dilemmas of recent vintage: a new environment

- The eurozone is, arguably, no longer menaced by a collapse (ECB’s actions and large macro-imbalance corrections in its periphery), but...
- Specter of debt deflation in the eurozone;
- the link between sovereign debt and bank balance-sheets has not been severed;
- fragmentation of markets (although the periphery pays much less for issuing its debt...)
- Internal demand is very weak suffering from the negative loops between weak activity, fragile banks, weak firms, diminished incomes, and the need for fiscal consolidation
- The bottom line: how to foster economic growth?
- The breakdown of the growth model that relies on heavy capital imports
- The fallout from the Ukraine crisis on economic recovery in Europe (geopolitical risks); other geopolitical risks (The Arab world...)
- Capital flows reversals (risk aversion)
- Fed’s tapering of its stimulus
4. Dilemmas of recent vintage

- **The policy space** issue (apart from fiscal space)
- Diminishing inflation has allowed a relaxation of the monetary policy rate to 2.75% in November 2014; there is room to continue easing by reducing the policy rate and reserve requirements; caution in view of Fed’s tapering impact, the balance-sheet effect and a prospective rise of inflation in the second half of 2015
- A threat of the zero lower bound in Romania? Highly improbable in the near future...
4. Dilemmas of recent vintage

- Does joining the Banking Union make sense?
- How to manage monetary policy and financial stability policy in a central bank
- The need to develop capital markets
- More local banks?
- Rethinking the growth model (fostering comparative/competitive advantages)
- Joining the euroarea is a political commitment and decision; the euroarea needs to solve its problems and Romania’s economy become stronger
4. Dilemmas of recent vintage

- Macro-prudential considerations will play an increasing role in the conduct of macroeconomic policy: the pluses and minuses of deep financial markets (size of economy, participation of domestic investors, the international policy regime)

- The governance of the eurozone? Its fiscal undepinnings are very precarious

- The reform of the banking (financial sector): size; its speculative nature; shadow banking sector (the return to Glass Steagal does make sense)

- The big players’ role in global and European financial cycles; do they care about the externalities they produce? A new Bretton Woods is needed (international policy coordination): conceptual issues; avoiding the “dark corners” (O. Blanchard)
Thank You