Stocktaking of Central and Eastern European Economies under Pandemic (platform for discussion for the BIS Monetary Policy Round)

Ana Mitreska
National Bank of the Republic of North Macedonia

(19 May – virtual meeting in Basel)

Setting the stage

- **A unique pandemic crisis** plunged the world into a recession

- **The CESEE countries - not shielded**, given the severity and the global synchronization of the crisis

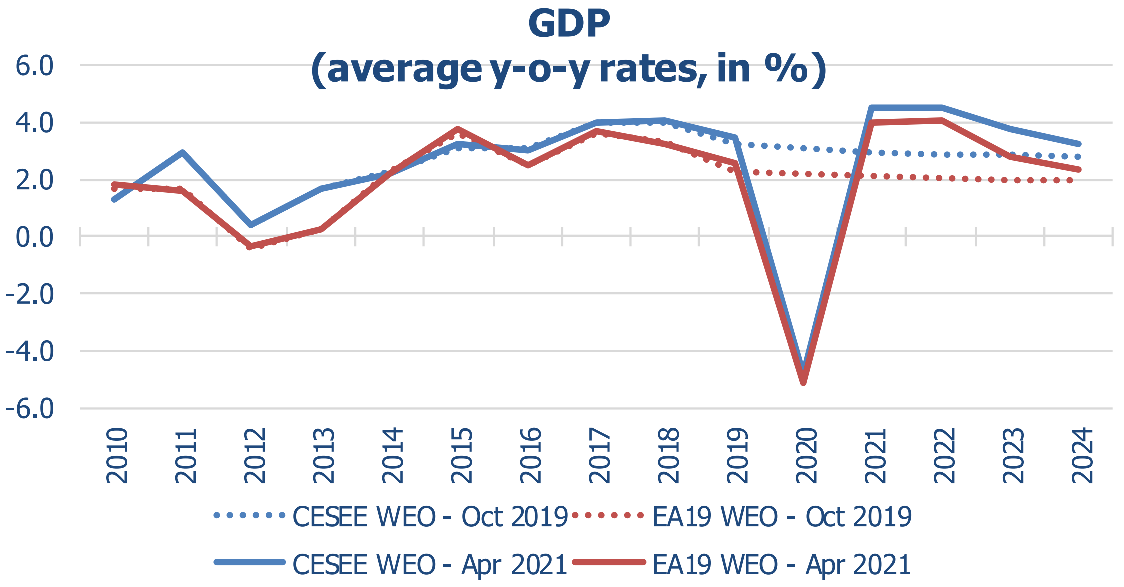
- Divergence in the impact conditioned on the **structure of the economies**, their **pre-crisis fundamentals** and the **available policy space**

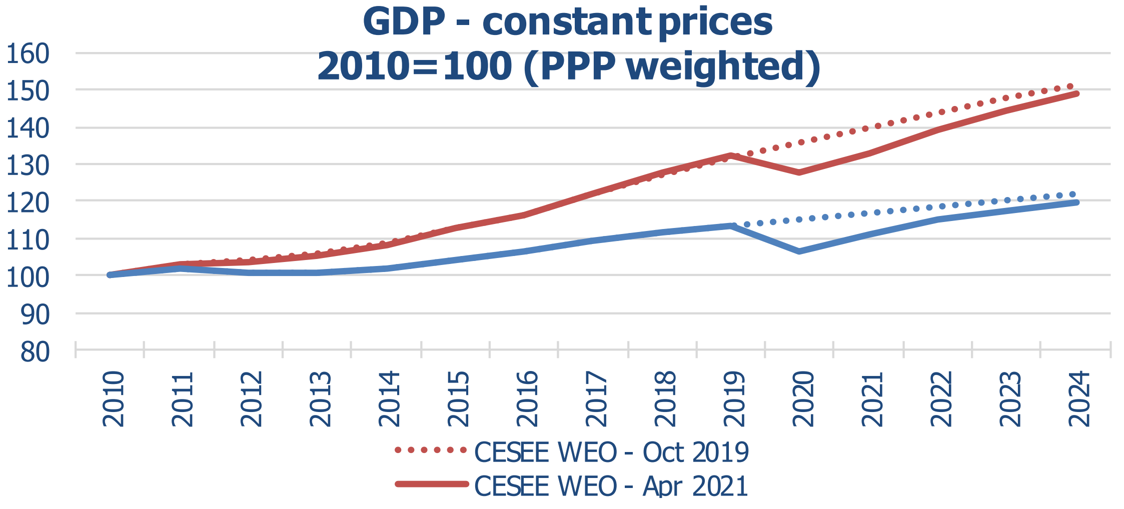
- **Massive** and **prompt policy support** of the advanced economies – enabling very fast normalization of the financial conditions

- **Conducive for the external financing** of the CESEE countries, **underpinning their policy support** to curb the economic costs of the crisis

Can we measure the economic loss?

- **CESEE economies were on a strong footing before the crisis**, growing at an average growth rate of 3.5% in the last couple of years
- **The health crisis interrupted the economic growth** pushing economies into a recession, with a GDP drop of close to 5%
- The lockdown in the second quarter, subsequent containment measures, loss of confidence and the disruption of the global supply chains severely hit all the demand components
- Despite the expected recovery, **GDP level to slowly converge to the pre–pandemic forecast and in 2024 to remain below it by around 2%, very similar to the expectations for the EA**

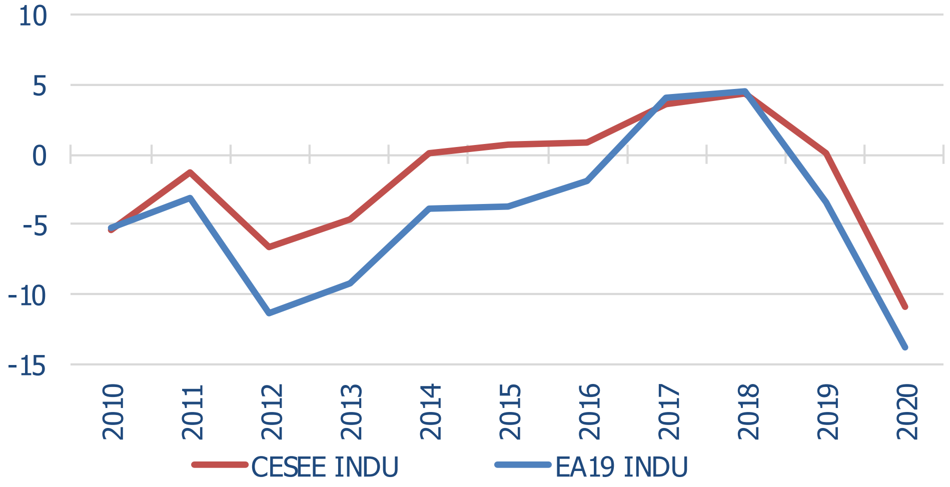




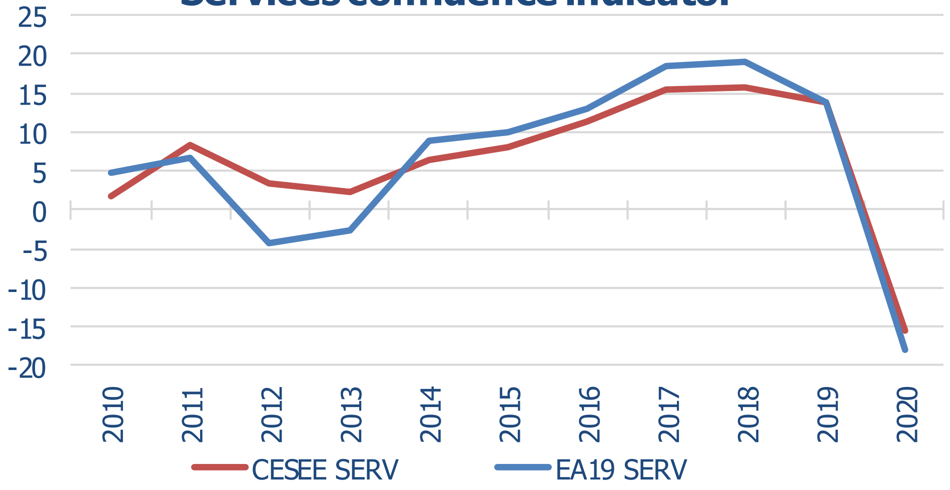
Sources: WEO database October 2019, April 2021 and own calculations.

Confidence dipped to unprecedented levels

Industrial confidence indicator



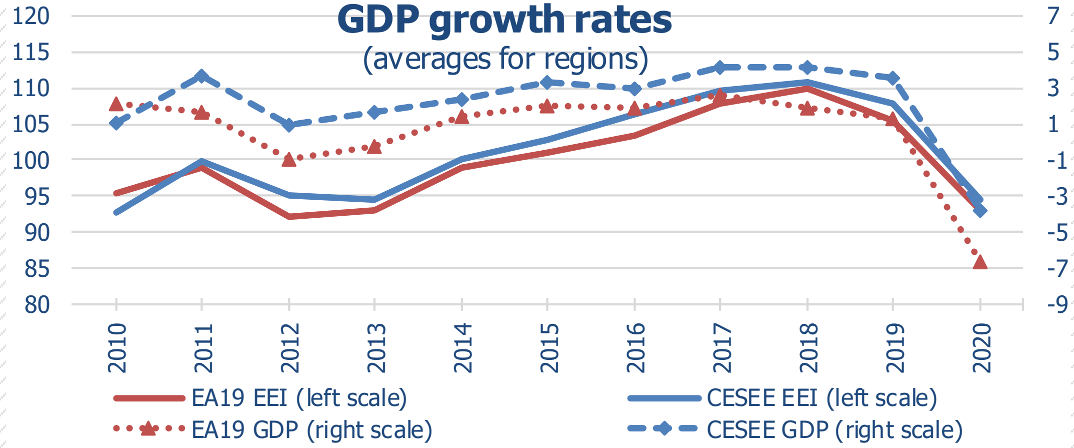
Services confidence indicator



Source: Eurostat and EC - Business and consumer surveys.

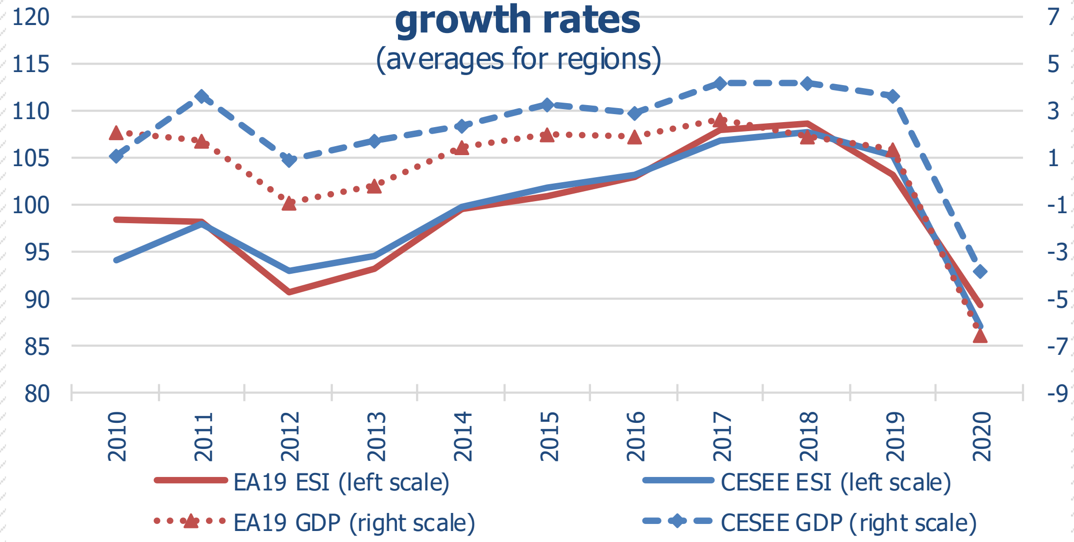
Employment expectations indicator and GDP growth rates

(averages for regions)



Economic sentiment indicator and GDP growth rates

(averages for regions)



Source: Eurostat and EC - Business and consumer surveys.

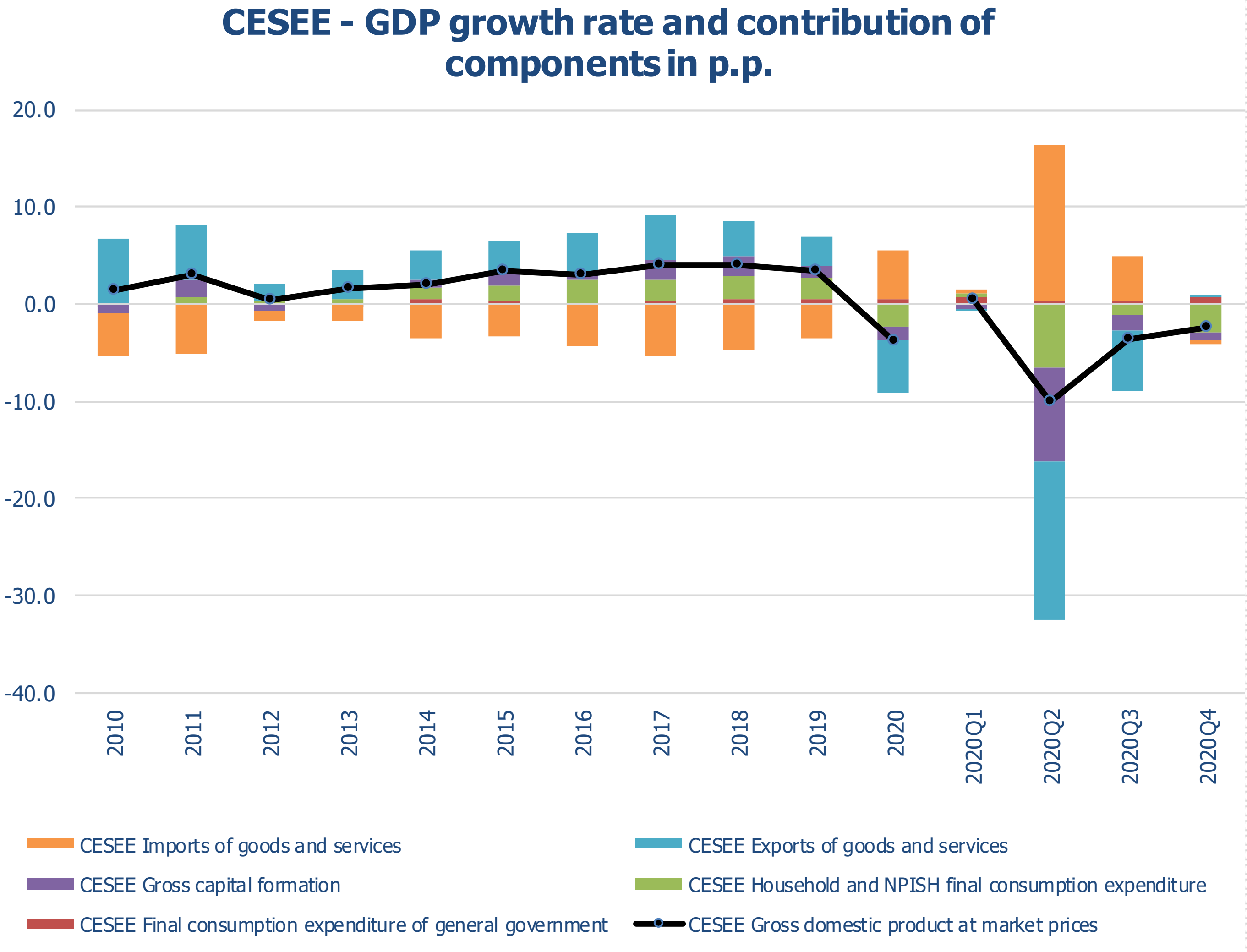
Drivers of the economic slack in 2020

- **Given the severity of the crisis and measures undertaken, marked decline was visible across the board**

- **Consumption and investment plummeted**, amidst rigid restrictions, loss of confidence, uncertainty for the future income

- **Given the trade openness and integration in the global value chains – export** dropped initially, but recovered very quickly

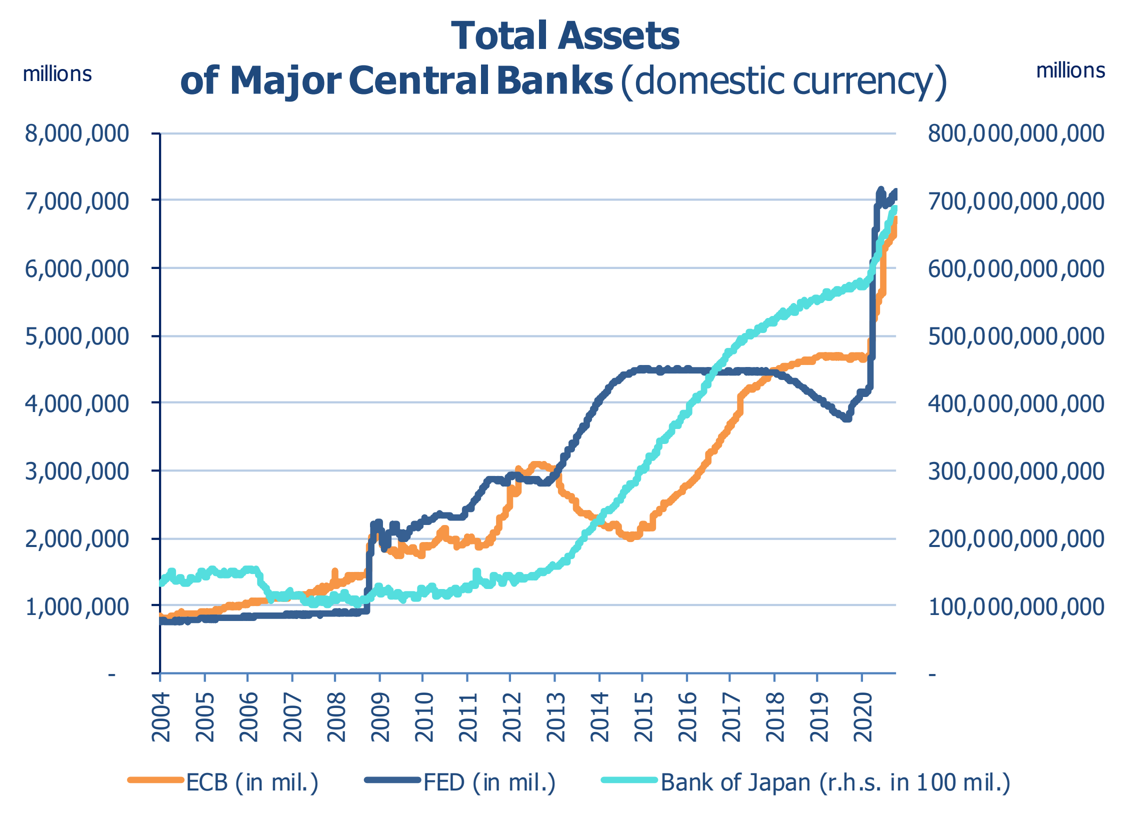
- **Different structures of economies and policy space –** implied divergence in the magnitude of the recession and the sources of the fall in the activity (from around 1% in Serbia and Lithuania, to 8% in Croatia)



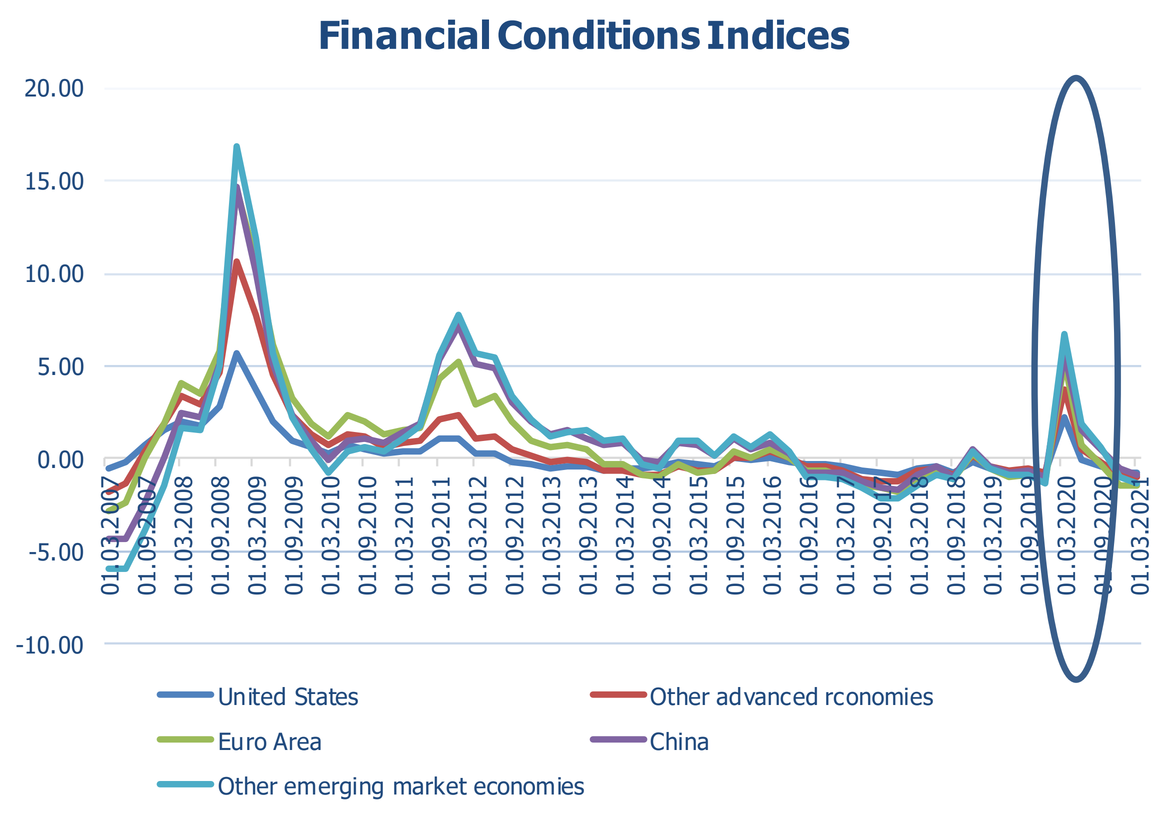
Source: Eurostat and own calculations

Outcomes would have been poorer in the absence of unprecedented and swift policy reaction

Further Monetary Policy Accommodation



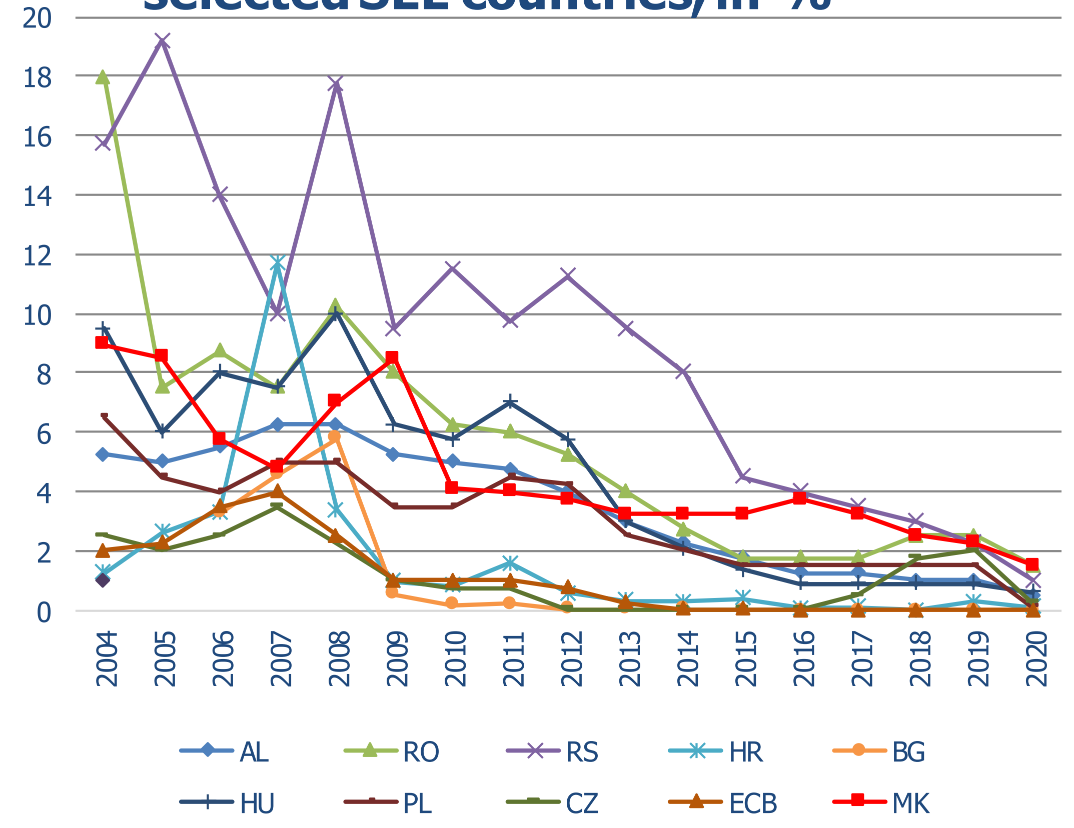
Enabling very fast normalisation of the financial markets



Central banks in the region responded in the same accommodative mode

- **Conventional measures:** cuts in the policy rate
- **Exchange rate policies** interventions on the forex market
- **Financial sector policies** regulatory flexibility to sustain credit flows and lighten the financial burden of corporates and households
- Some countries in the region embarked on **purchase of government bonds** on the secondary market (Croatia, Hungary, Poland, Romania)

Central bank interest rates in selected SEE countries, in %

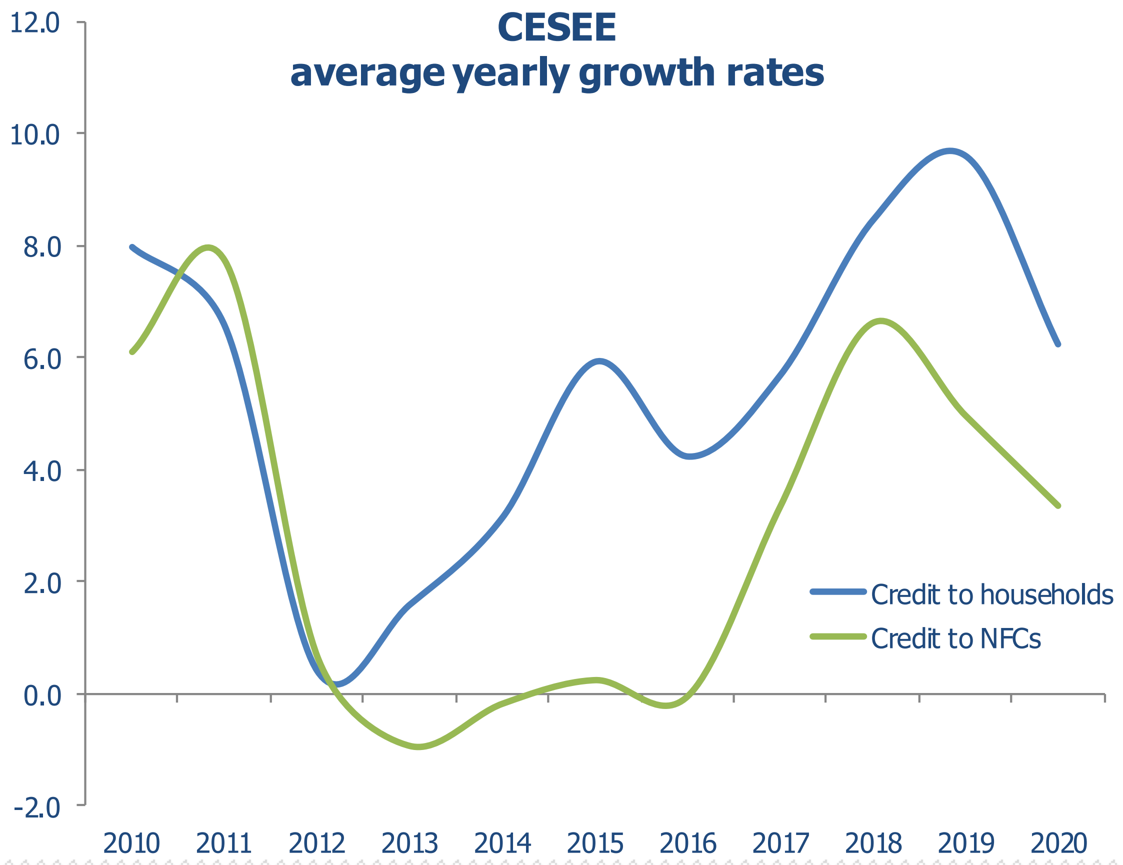


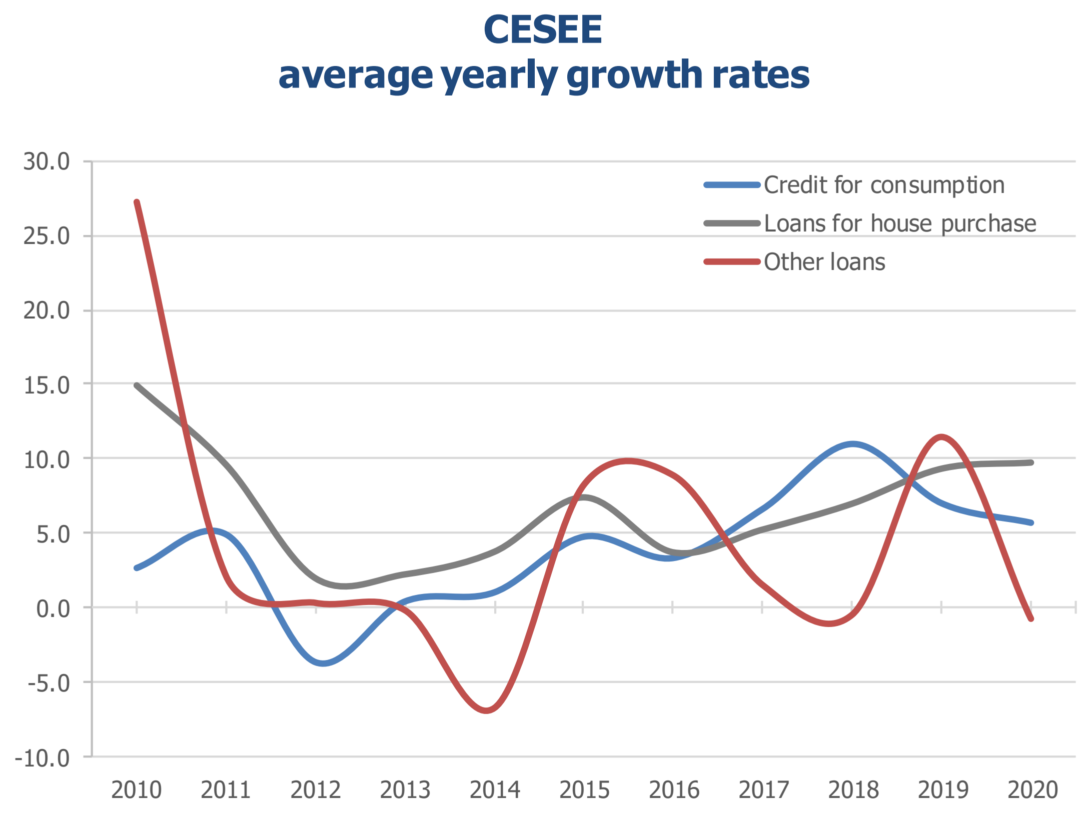
Sources: National central banks, ECB, IMF and BIS.

Accommodative monetary and financial sector policies conducive for the credit market

Credit flows to both, households and corporates **slowed, but remained positive** in most of the countries

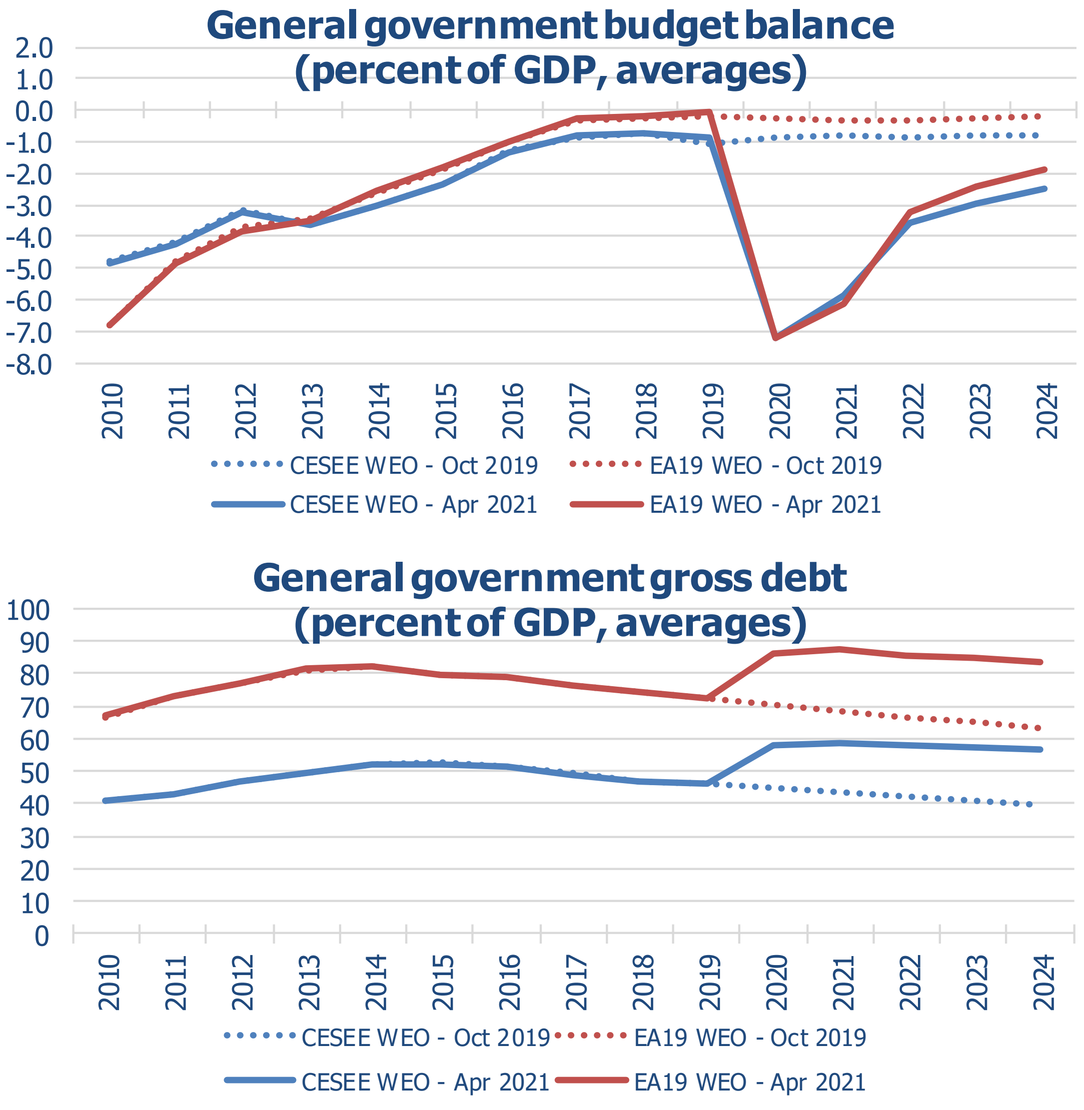
Stronger growth of housing credits, as agents invest in real estate amidst uncertainty - exposing the banking system more to the dynamics of the real estate market





Large Fiscal Interventions

- **Large fiscal interventions in the region** to contain economic losses, and protect jobs and income
- **The crisis reversed the favorable fiscal position** with almost balanced deficit and brought it to a level of around 7% of GDP
- **Hence, the public debt level** was elevated by close to 12 pp in only one year, departing from the pre-pandemic expectations by similar magnitude

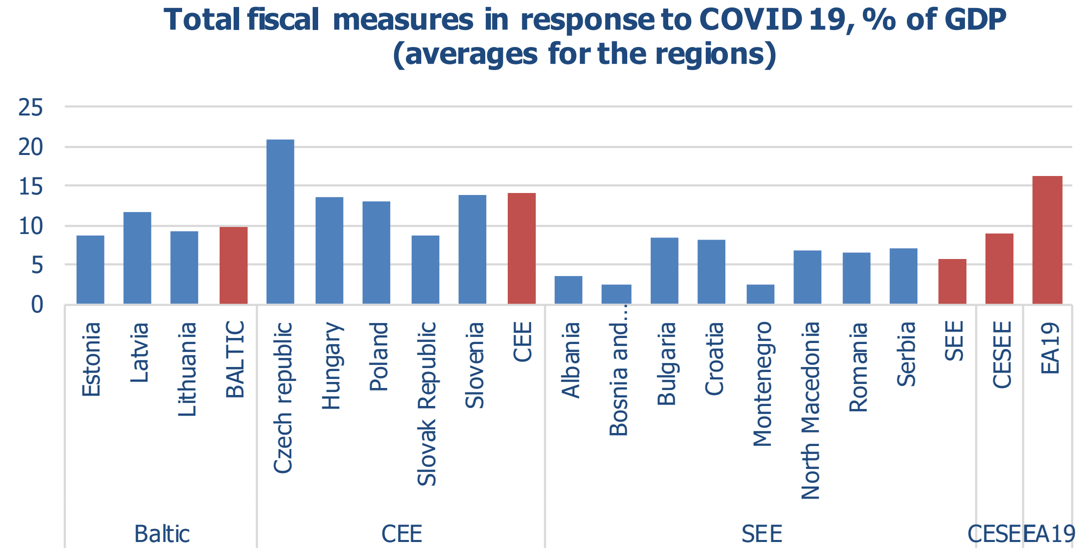


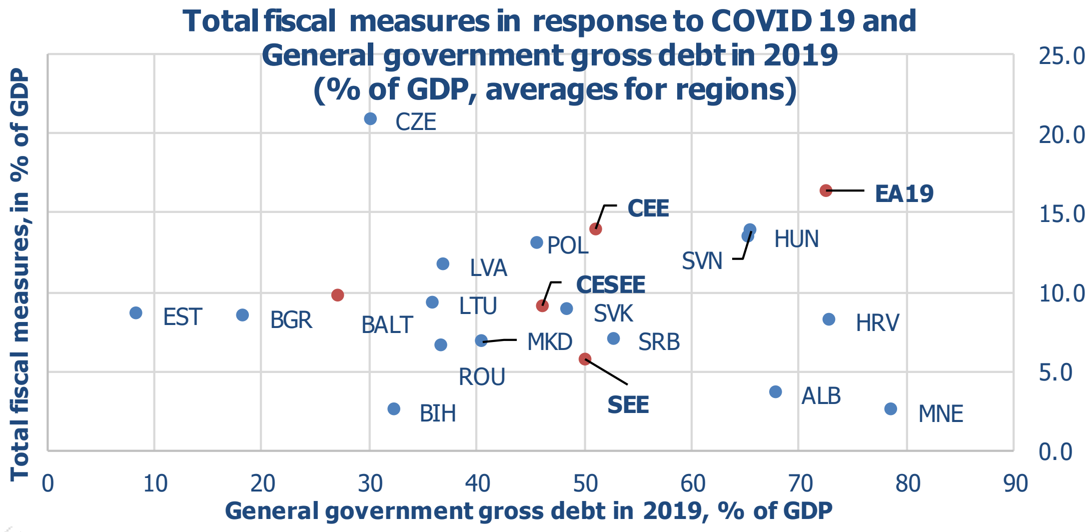
Sources: WEO database October 2019, April 2021 and own calculations.

Large Fiscal Interventions

- **Total fiscal stimulus –** heterogeneous among countries and country groups with the largest impulse in CEE countries, and the lowest in the region of SEE

- **Unlike other crisis episodes, the fiscal stimulus was only partially conditioned on the initial debt level –** indicating the necessity to spend and support the economy, safeguarded with the uninterrupted access to international financial markets and IFI's.





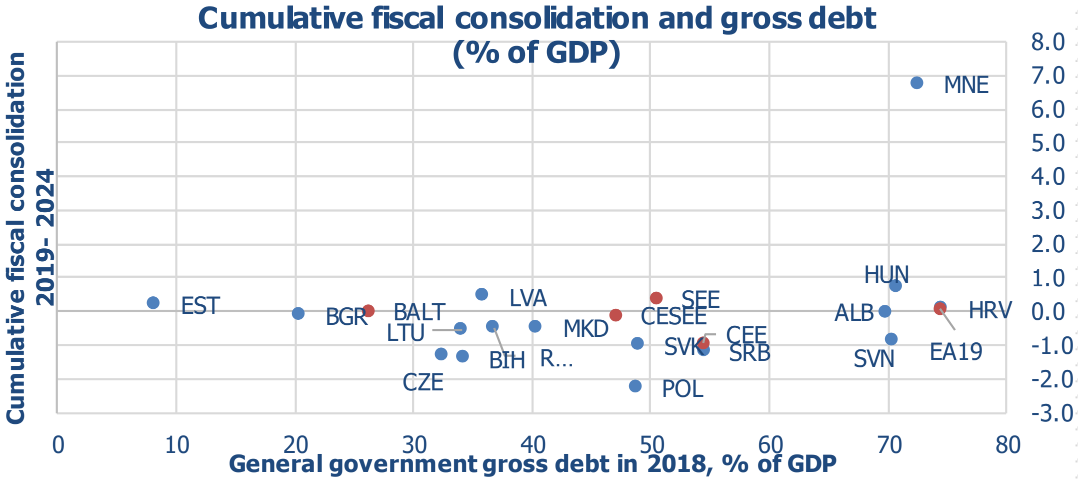
Sources: IMF WEO database April 2021, Fiscal Monitor and own calculations.

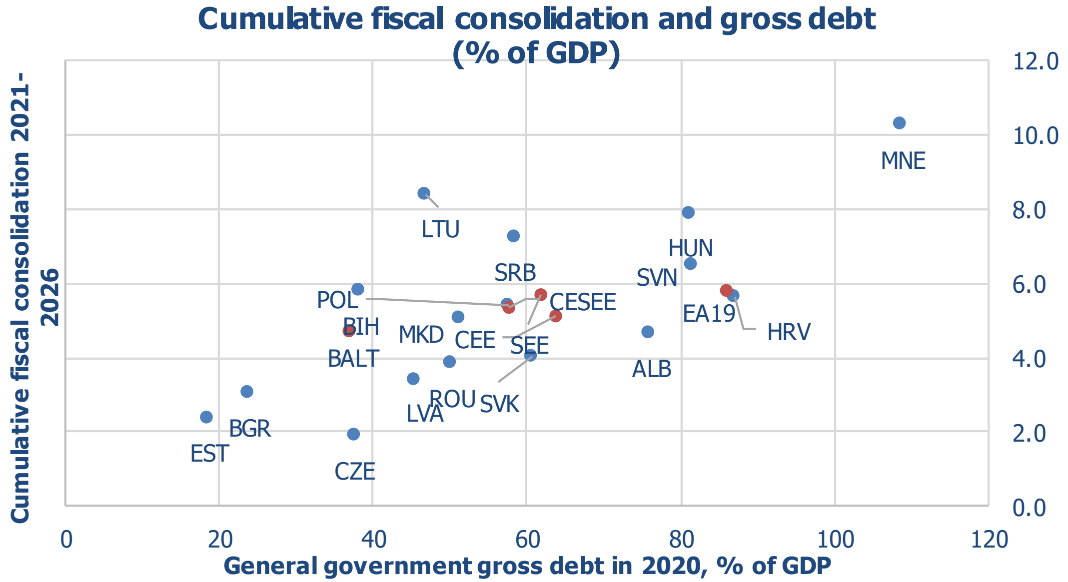
Fiscal consolidation

- **Warranted fiscal consolidation,** but cautious until growth is more sustained

- **Consolidation in the next couple of years on average of around 5 pp** of GDP, with the size being positively correlated with the initial debt level

- **Expansive fiscal austerity, through proper design in different stages of the pandemic –** from broad based job and income preservation to targeted support to viable firms for transformation of the economies and lifting growth potential

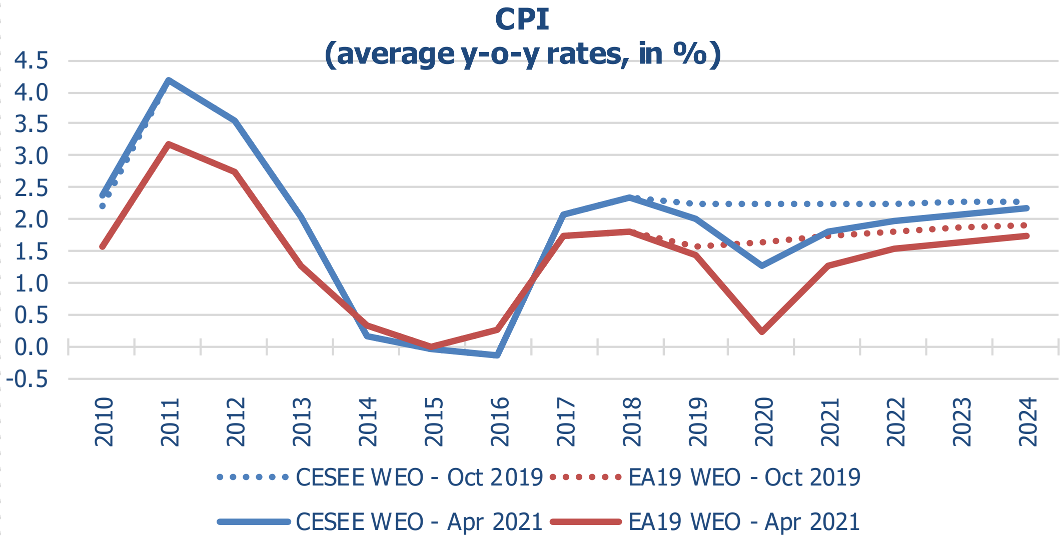


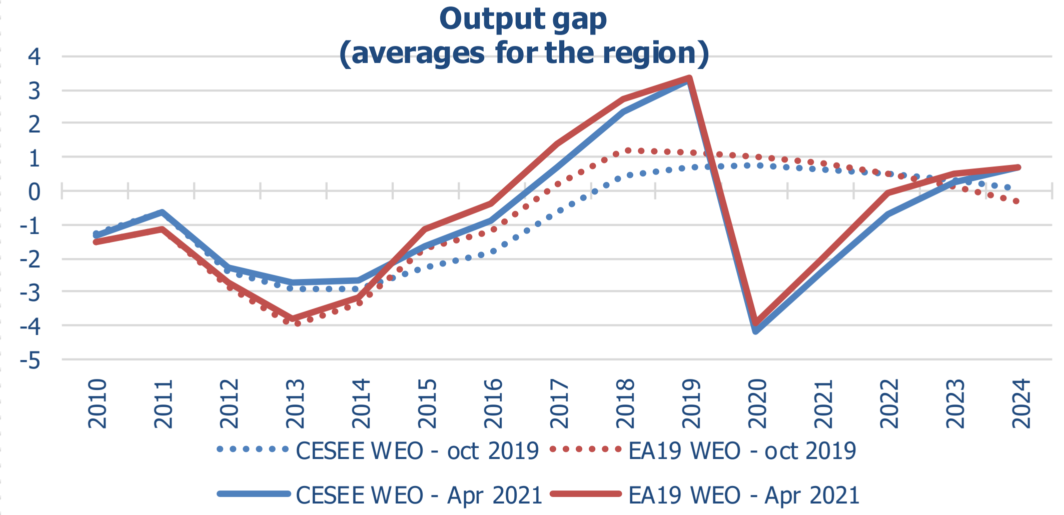


Sources: WEO database October 2019, April 2021 and own calculations.

Inflation on the Surface?

- **Prior to the pandemic –** debate on possible inflation spurring, on the backdrop of cyclical upturn, rising wages and narrowing profit margins
- **The outburst of the pandemic** brought the inflation below the pre-crisis forecast, driven by containment measures and depressed demand
- **Inflation forecast to converge to the pre-crisis one, but some uncertainties ahead**: rise of commodities prices, further compression of profits and faster cost pass through, change in the behaviour of economic agents, disruption in supply chains, rapid digitalisation, abrupt demand growth – **possible and uncertain impact on the price formation process**



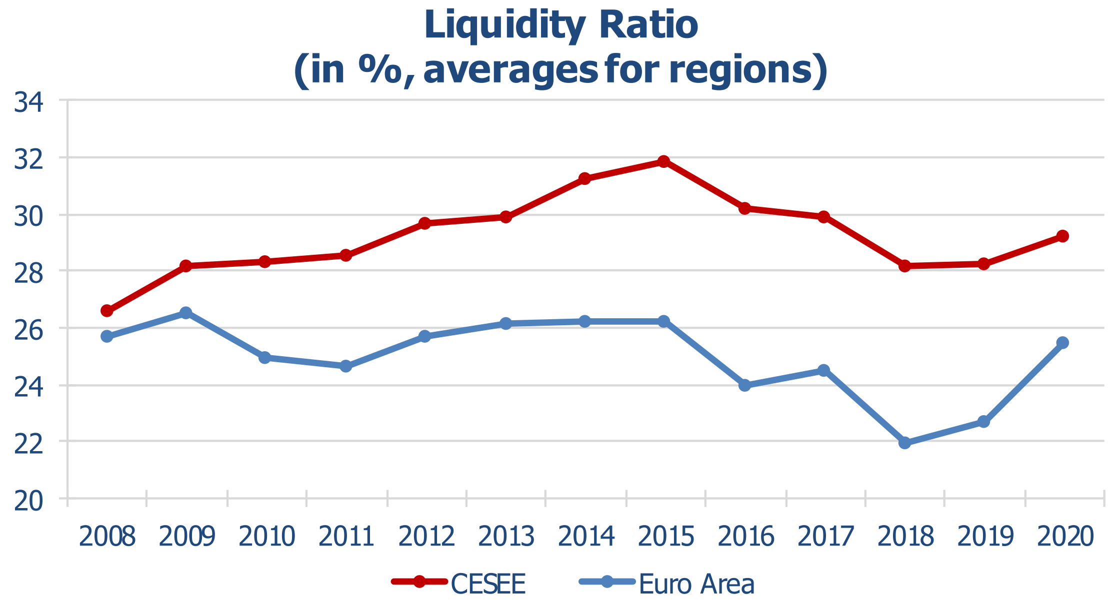


Sources: WEO database October 2019, April 2021 and own calculations.

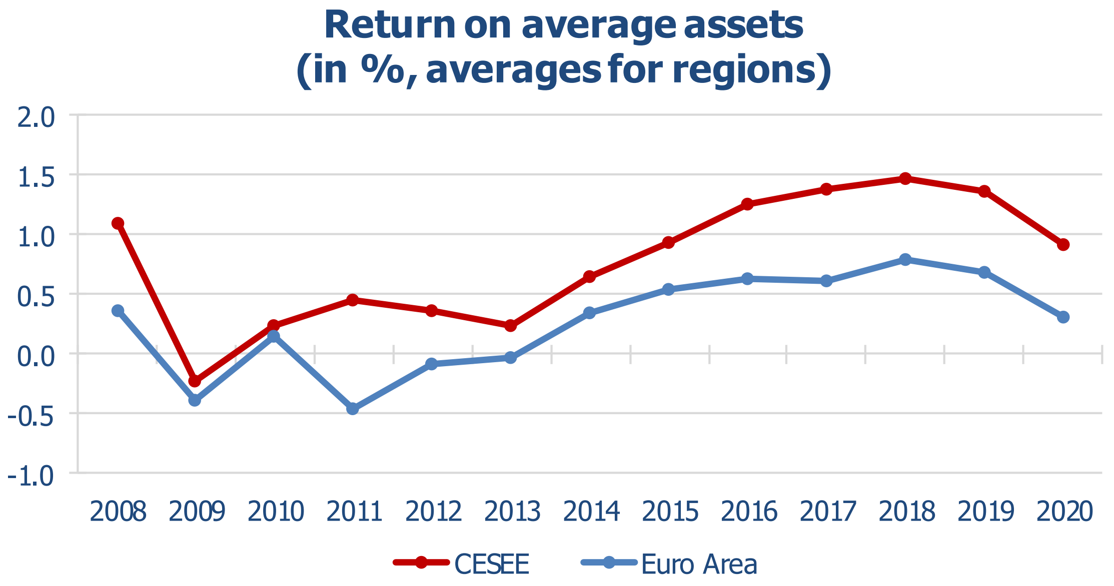
Strong bank's fundamentals prior to the crisis – strengthened during the first pandemic year

Liquidity remained robust, and increased in 2020 further on - a trend visible in the region and the euro area , as well

Profitability under pressure in a low interest rate environment and rising impairments, but remained in a positive zone and above the one in the euro area



Sources: World Bank, IMF, National Central Banks and own calculations.

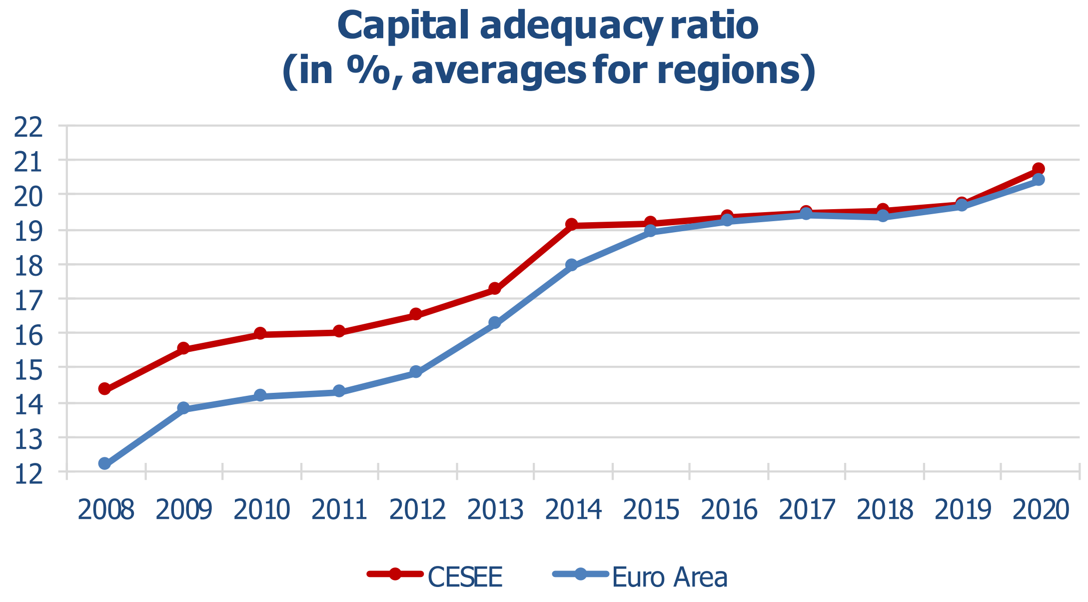


Sources: World Bank, IMF, EBA, National Central Banks and own calculations.

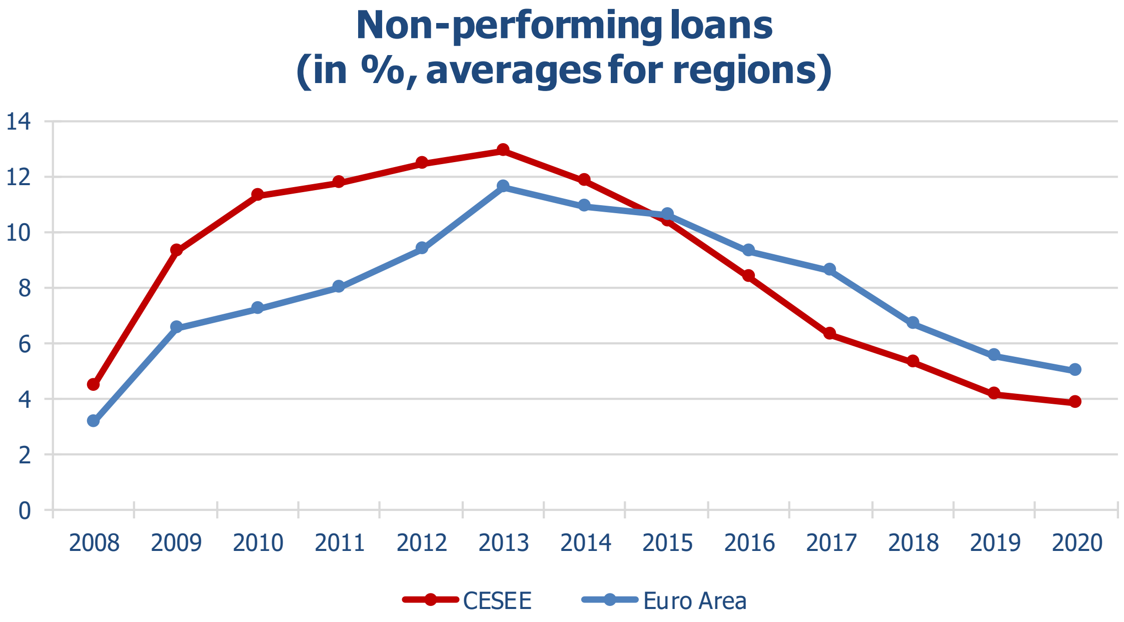
Strong bank's fundamentals prior to the crisis – strengthened during the first pandemic year

Tendency of improving solvency persisted, with CAR of the CESEE converging to the euro area and averaging 20.7% in 2020…

…which in confluence with the falling and low NPLs provide room to cushion possible adverse developments



Sources: World Bank, IMF, National Central Banks and own calculations.



Sources: World Bank, IMF, National Central Banks and own calculations.

Despite the strong buffers, some challenges ahead

- **Policy measures undertaken –** alleviated the burden on banks and clients temporarily, but may prove distortionary down the road

- **Main challenge** – to preclude misallocation of resources, zombification and accumulation of NPL's

- **IMF Guidelines (2021)**
- **Replace blanket freezes on debt repayments, foreclosures, and insolvency proceedings with targeted** support to distressed but viable borrowers

- **Balance sheet positions -** asset classifications should accurately reflect risks; banks with high NPLs to develop internal NPL management capabilities

- **Profitability and capital distributions.** Restrict dividend distributions and share buybacks while bank profitability remains distorted due to emergency measures, and while the quantum of eventual losses remains highly uncertain

- **Intensify supervisory monitoring -** require banks to continually assess borrowers' creditworthiness until conditions have normalized; assess financial conditions under different scenarios including through stress testing

Headwinds Ahead

- **The economic recovery with headwinds –** resurgence of pandemic might entail "stop and go" mode of economic upturn and protracted recovery

- **Scarring of the economy –** if crisis persists, it might damage the supply potential through lower labour participation, corporate bankruptcies, disrupted networks

- **Tightening of global financial conditions –** sudden shifts in investor's sentiment and risk reappraisal could make access to finance more difficult and increase refinancing risks of the countries with high debt levels

- **Expected divergence of recovery –** faster of the advanced and slower of the less developed countries might ask for monetary policy tightening in the first group, while the latter one is not prepared for changing the policy stance…

- **…particular risk for countries with stable exchange rate**, that follow the policy of anchor central bank

How to Cope with the Headwinds?

- **Strengthen the resilience –** proceed tackling **the pre-pandemic structural bottlenecks** (institutions, rule of law, human capital, the capacity to innovate and diversify the economic structure)

- **Keep pace with the post–pandemic needs –** focus the policy support to new business models imposed by the crisis, support competiveness and growth

- **Proceed with policy support** – but **rebuild policy space** and preserve stability