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info@nbrm.mk
www.nbrm.mk

HURDLES TO THE GROWTH AGENDA OF THE CESEE ECONOMIES

Anita Angelovska Bezoska, Vice Governor
Ana Mitreska, Director of MPRD[1]

[1] Monetary Policy and Research Department.

Hurdles to the Growth Agenda of the CESEE Economies

The note will strive to tackle the growth issue in the CESEE region[2], by scrutinizing the current growth performances, the envisaged growth outcomes in the period to come, and the extent to which certain growth drivers can act as boosters or hurdles to the growth agenda. The impetus for such a choice in our economic scrutiny is straightforward. Eight years after the onset of the global crisis, it does not seem that the question of how and to what extent economic growth should be reinvigorated lost any of its contemporaneity. It is on the top of the policy agenda in many countries. In the euro area in particular, as within the monetary union, growth momentum is difficult to be ignited. Of course, the CESEE region is not an exception in this respect. Most of the countries in the region are highly open economies with strong trade and financial linkages with the advanced European countries. Hence, external headwinds related to the euro area recovery and financial markets developments, as well as some country specific fundamentals might act as hurdles for the medium run growth prospects of the region as a whole.

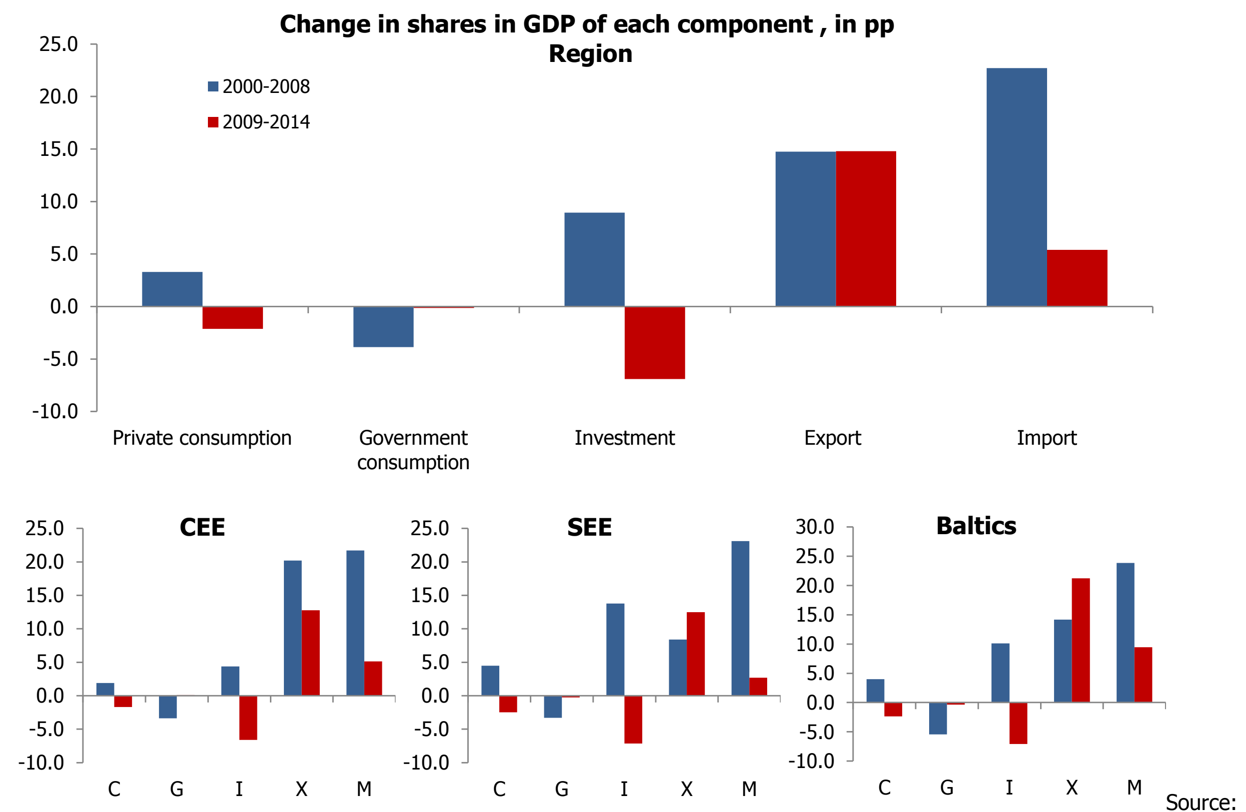
The process of gradual post-crisis economic recovery in the region continued in 2015 bringing the region slightly above its pre-crisis peak, on average. In most of the countries in the CESEE region, growth, although still modest, slightly accelerated with average growth rate projected to reach 2.4%. For the first time after the crisis, in 2015, all countries in the group were expected to register positive growth rates, with the highest growth rate being reported in the Czech Republic (3,9%) and the lowest in Croatia (0,8%). The average GDP level of the region is estimated to outpace the pre-crisis level of about 4%, with Macedonia, Albania and Poland having the strongest outperformance of around 19%. This group seems to be marked by country-specific growth boost factors – structural reforms, government stimulus, or sound fundamentals. The rest of the countries either are only slightly above, or are still below their peak levels. This prevalence of "slowly growing" economies in the region in the past several years is a first litmus to show that the factors in play, which should underpin growth, do not seem to proliferate recovery vividly enough.

The growth structure did not change significantly in 2015, i.e. the trend of rising share of export and import, and declining share of investments and consumption, in GDP continued. The share of exports and imports in GDP continued to grow at a similar pace and thus the share of net exports remained broadly unchanged, but compared to the pre-crisis period, still there is a visible improvement explained by the faster growth of exports compared to imports. Apparently, despite the crisis, the export sector of the countries in the region managed to grow further, and it is particularly

[2] Includes Macedonia, Albania, Croatia, Bulgaria, Montenegro, Bosnia and Herzegovina, Serbia, Romania, Slovenia, Czech Republic, Poland, Estonia, Hungary, Lithuania, Latvia, Estonia.

pronounced in the case of the Baltics. The internal devaluation process in some of the countries and the structural reforms in the external sector in others, explain to a certain extent the improved export position. On the other hand, the share of investments continued to decline, falling from 30% (average for the region) in the pre-crisis period to about 23%, meaning a full reversal of the pre-crisis growth. The level of investment is much lower in all of the countries, with Poland and Macedonia being the only exception (in Macedonia the current level is by 40% above 2008, a result of foreign and public investments). As for the private consumption, its share continued to slightly decline and currently its level in most of the countries is somewhat lower compared to the pre-crisis period. The government consumption remained stable at the level of 18% of GDP.

Chart 1: Expenditure components of GDP

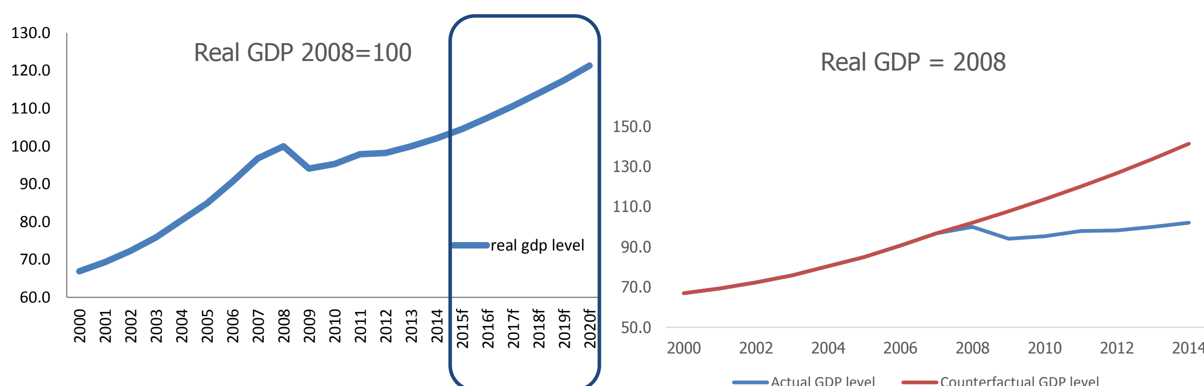


Source: Eurostat; Authors' calculations.

The prolonged lackluster growth moves the region away from its previous trajectory in the real convergence process pointing to a new "normal" at a lower equilibrium. At the current juncture, it seems that on a medium-run, the pre-crisis mode of fast growth amidst liquidity glut and higher risk tolerance cannot be expected. The IMF baseline scenario for the next six years points to a further gradual acceleration of the growth to 3.2% in 2020, pointing to a significantly lower dynamics than in the pre-crisis period. In many of the countries, where the crisis revealed large deficiencies in their

economic fundamentals, the distance to the pre-crisis growth dynamics is quite large. If we run a counterfactual analysis, applying the average pre-crisis growth rate to the GDP level in 2007 - before the crisis started, the simulated outcome is much higher compared to the current state. The simulated level is by 40% higher compared to the actual one (Chart 2, the second panel), but also significantly higher than the baseline forecast for 2020. Hence, this simple simulation clearly points to a new environment in which growth factors cannot return to the pre-crisis mode. Although, to some extent, this reflects an adjustment from an unsustainable boom-type of pattern, in the Baltic States in particular, there is still a room to pinpoint pale growth drivers in the period to come.

Chart 2: Real GDP level, actual, forecast and counterfactual



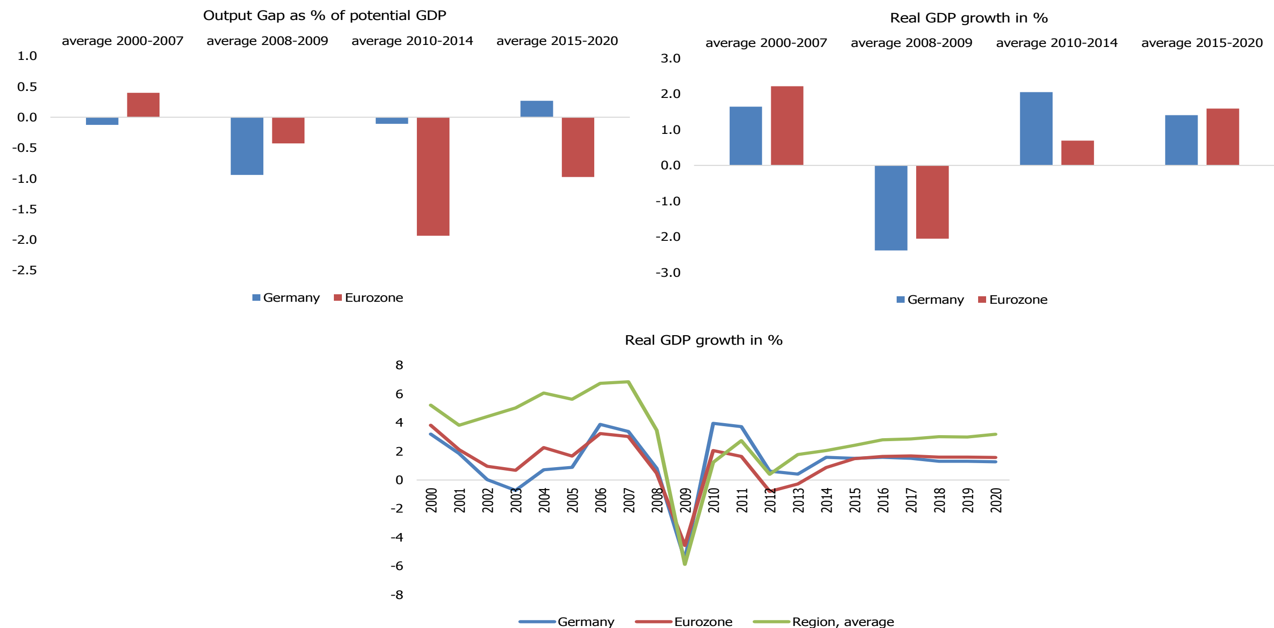
Source: International Monetary Fund, WEO Database, October 2015; Authors' calculations.

High and rising openness of the countries in the region with tight trade and financial linkages with the EU underlines the importance of the external demand as growth factor. After the sharp fall of the trade flows during the pick of the crisis, since 2009, the trend of rising trade openness has continued in almost all countries reaching 104% of GDP on average for the region (7 p.p. higher compared to 2008). The highest openness can be observed in the Central European countries of about 150% of GDP. Importance of the EU, as a main trading parting for the region, has continued to increase with about two thirds of the exports channeled to the EU. In particular, Germany seems to be an important trade partner accounting for about 17% on average of the exports with notable exposure of the Central European countries (close to 30% of the exports).

European economy is expected to continue to recover, although moderately and thus it is not expected to provide strong boost to the growth dynamics in the region. The ECB quantitative easing coupled with weakening of the euro have contributed to improved growth prospects. Still, the potential growth of the euro area seems to have weaken, mirroring crisis legacies,

demographics, and decline of the total factor productivity, which started even before the crisis.[3] Notwithstanding the estimated slowdown in the potential growth, still the forecast for the next couple of years does not indicate a possibility for the euro area to close its output gap, and therefore, it will remain negative. The positive aspect is that the German recovery has been better compared to the average in the euro area with expectation of entering the zone of positive output gap.

Chart 3: Growth and output gap in the euro area and Germany



Source: IMF, World Economic Outlook, October 2015.

Recent slowdown in some emerging markets (notably China) poses some challenges for the growth prospects of the region. The direct links between the CESEE counties and China are weak, as the share of domestic value added from the region consumed by China is less than 2% of CESEE countries' GDP (with highest exposure of the Slovak and Czech Republics and Hungary). In this vein, IMF study estimates that the spillover effects of the Chinese slowdown via the real channel will be fairly small assuming that countries have fiscal and monetary space to act counter-cyclically. However, Chines slowdown may imply more general slowdown in emerging markets and subsequently stronger spillover effects on the European economy, particularly in the manufacturing sector of the German economy, and indirectly, in the CESEE economies. China is one of the top five export partners of Germany, accounting for about 7% of the German export. Also, having in mind the role played by China on international primary commodity markets, it poses risks for countries exporters of metals, but in the same time creates

[3] For reference, see the IMF, World Economic Outlook, October 2015.

positive risk for energy importing countries. Higher uncertainty may adversely affect investors' confidence, risk premiums and result in spillover effects through financial channel, as well.

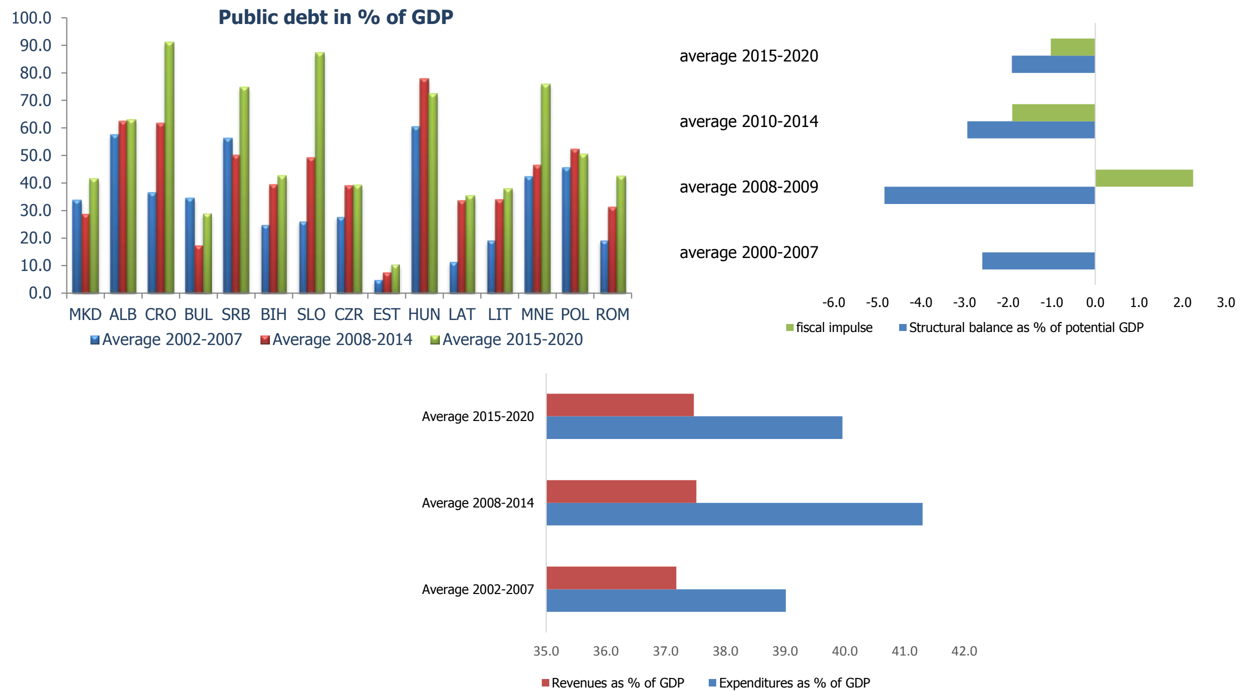
Despite the post-crisis downward adjustment of the external financial exposure of some of the countries in the region, it remains elevated. The international investment position indicates that the strong rise in the gross external liabilities observed in the pre-crisis period was discontinued with the emergence of the crisis. The post-crisis downward adjustment was the largest in the Baltic States, while in the other two groups it continued to increase, but at a far slower pace than before. Yet, the external liabilities remain high mainly due to public sector borrowing, namely, in almost all of the countries, liabilities are more than 100% of GDP with sizable share of debt-creating flows-implying still high vulnerability of the region to any financial markets turbulences.

Given the constrained external environment, it is of interest to shed some light on several domestic factors and to assess their impact in the context of growth. When it comes to the fiscal stance in the region, it appears that, despite the fiscal consolidation efforts, it is not yet complete and that it may continue to weigh on future growth. The trend of gradual narrowing of the general government balances has continued across most of the countries in the region, but at a pace insufficient to stabilize the public debt level. Thus, public debt continued to rise across the whole region with an exception of a couple of countries (on average, the public debt reached around 53% of GDP). In 6 countries, the level exceeds the threshold of 60% of GDP, and even more, the latest IMF forecast again does not point to room for a more significant adjustment.

The issue of how to reconcile the fiscal consolidation with the need to boost the growth will remain as one of the key challenges in this regard. The scrutiny of the structural balances reveals that after 2009 fiscal impulse has been negative, and the latest IMF forecast shows that more or less the same pattern prevails in a medium run. Thus the need to further increase the growth friendliness of the budget structures remains. The IMF index that measures this budget dimension indicates that many of the countries managed to improve the budget structures in a way that positively affects the growth, though the progress was more visible on the revenues side i.e. shifting taxation away from direct to indirect taxes and property taxation. On the expenditure side, there has been limited progress in reducing high transfers and wage bills. Overall, public expenditure levels are still high and expenditure structure is similar to structures of advanced economies despite the lower income level.

Chart 4: Fiscal profile[4]

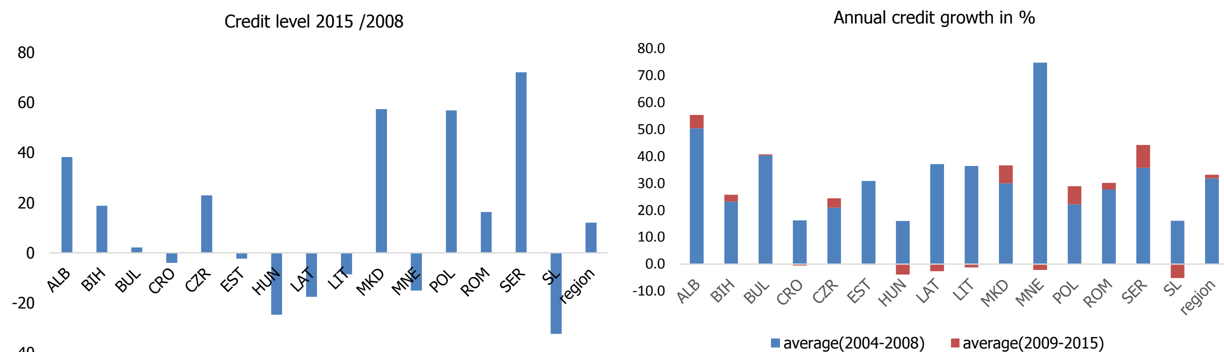
[4] Data for structural fiscal balances are not available for Albania, Macedonia, Estonia and Montenegro.



Source: International Monetary Fund, WEO Database, October 2015; Authors' calculations.

The experience of the countries in the region regarding the role of the domestic credit finance in supporting growth is quite diverse, but generally many countries still struggle with anemic credit support. The average credit growth of the region in the last couple of years has been hovering around 1%, although there are high variations among countries. The intensity of the post-crisis downward adjustment was linked with the speed of the pre-crisis growth, and the sources of its financing. In those countries where pre-crisis growth was high, the post-crisis adjustment was also more intensive. This process was highly pronounced in the Baltic countries, while Montenegro, Croatia, Slovenia and Hungary can also been seen as part of a classical boom-bust cycle. In the rest of the region, although growing risks caused a slowing/decline in both credit supply and credit demand, the post-crisis adjustment was more moderate.

Chart 5: Credit to the private sector

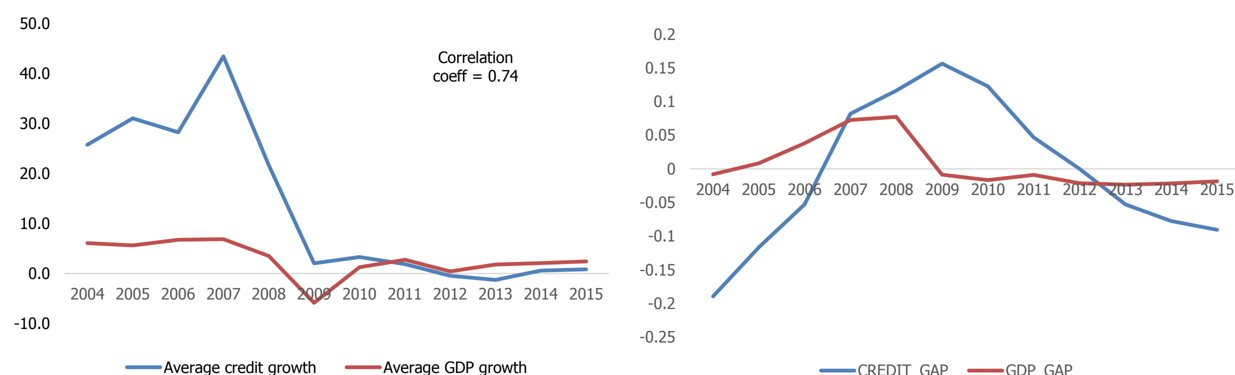


Source: Central banks' internet sites; Authors' calculations.

Taking into account the low rates of credit growth, on average, and the simultaneous challenge to accelerate the economic growth, the crucial question that arises is whether the banking system is in condition to intensify credit flows and thus support the economy as a whole. The screening of the key parameters indicates that the banking system in the region is generally sound. Although a slight decrease of solvency is evident compared to the pre-crisis period, in the last few years, the capital adequacy is more or less stable, averaging at about 17%, and thus exceeding the legal minimum more than twice. At the same time, the liquidity indicators point to the fact that the liquidity buffer is solid and that banks in the region are ready to absorb any potential liquidity shocks. The loan/deposit ratio dropped in all countries reflecting anemic credit growth thus pointing to a space for stronger credit support. Bank profitability is one of the points which certainly suffered serious consequences, after the onset of the global crisis. Taking into consideration that the income from interest on loans is the main source of income for the banks in the region, the slowdown in credit growth, even the decline in some countries, together with the environment of low interest rates, which creates pressure on interest margins, implied a decline in profitability of banks.

Despite the solid state of the banking system that implies adequate buffers to intensify credit support, there appears to be some limiting factors. One of the key legacies from the crisis is the worsened quality of the credit portfolio that significantly inhibits new credit flows. The average level of NPLs is around 13%, and this average has been relatively stable in the last few years. Indirect market risk, due to the foreign currency exposure of banks' balance sheets, and funding risk are part of these constraining factors. The financing risk is related to the so-called "forced" deleverage. The possibility of materialization of this challenge exists, and methods may vary, from the sale of banks that are systemically important for the countries in the region (outright divestment), to reduced financial support from parent banks, which in the absence of sufficient domestic resources, would mean reduction of credit support in the real economy. The introduction of the new Basel standards can also act as potential barrier for faster growth. It might reduce the availability of credit and increase the cost of financing. If on the backdrop of all these factors credit growth remains pale and thus act, as inhibitor of economic growth, there is high possibility the process of weak credit-weak growth to become self-fulfilling.

Chart 6: GDP and credit growth in %; gaps as % of potential (average for the region)

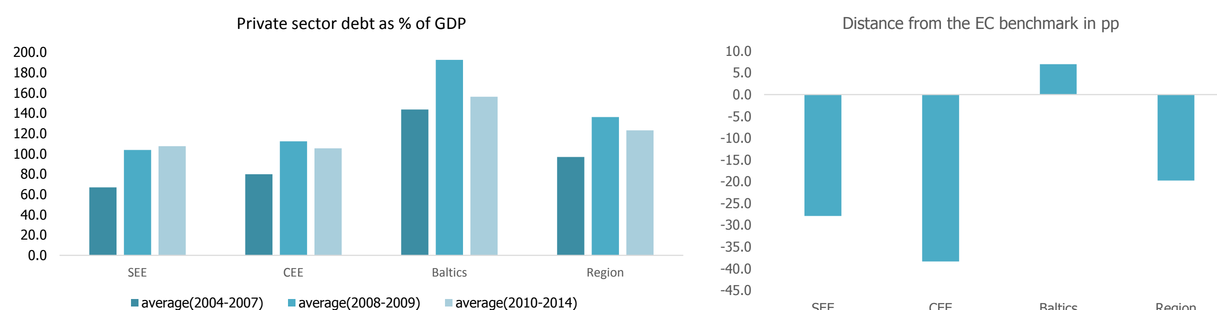


Source: IMF WEO database, October 2015 and central banks' websites; Authors' calculations.

The risk of the vicious growth-credit-growth cycle can be depicted in a very simple manner, namely, by observing the degree of synchronization of the credit and economic growth. The general notion would be that their trajectory is fairly coupled, and on top, in the post-crisis period, the dynamics seems to be quite in line, as well. With all the deficiencies, due to the lack of a longer consistent data series, still, the first check on where the economic and credit cycles stand, points to two conclusions. First, there is more or less a co-movement in both cycles, and second, both credit and growth seems to run under their potential at the very moment. This brings us to the puzzle of how the prospects of the credit-growth puzzle would look like in the period to come. Although the banking system is in sound shape to be growth supportive, the other side of the coin is the private sector, i.e., the process of repairing of the balance sheet of the corporate sector.

Despite the variations among countries, broadly, the trend of repairing corporate sector balance sheet through declining leverage that started with the occurrence of the crisis, continued in 2015. The emergence of the crisis interrupted the pre-crisis trend of sizable growth of the leverage of the private sector. In some countries, deleveraging of the private sector took place soon after the beginning of the crisis, reflecting financial and real sector constraints, somewhere as an effect of the growth in savings and fall in investment, and somewhere because of the faster economic growth. The most pronounced correction took place in the Baltic States that went through a severe boom-bust cycle. On the other end of the spectrum are a couple of countires that did not undergo adjustment at all, reflecting different country-specific factors. In some countries, capacity of payments or restructuring of the loans was insufficient, resulting in the persistence of debt. In others, the foreign investment cycle has not been terminated by the crisis (Macedonia for instance), thus the borrowing of the corporations from their parent companies increased. In some countries, the soundness of banking system was strong enough and the flows of lending to the corporate sector have not stopped.

Chart 7: Private sector debt and distance from benchmark



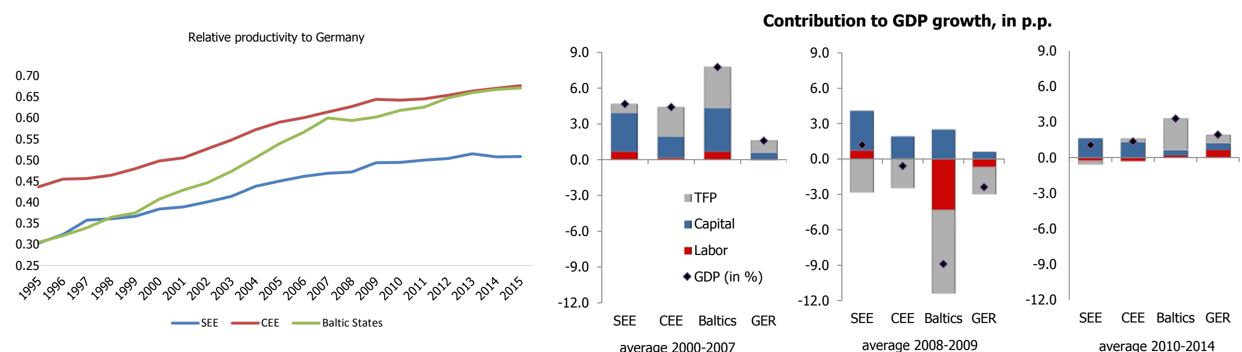
Source: Central banks' web sites; Authors; own calculation. Distance calculated as difference between 2014 level and the benchmark.

Although the current level of private sector debt in most of the countries in the region does not seem to be worrisome, still the process of deleveraging may proceed further and act as a limiting factor for the short-term growth prospects. For instance, it equals 113% of GDP in 2014, and is below the benchmark of the MIP scoreboard of the EC, which indicates private sector debt above 133% of GDP, as a threshold above which leverage becomes threat. Even more, if we control for the Baltic States, the average is much lower, i.e. around 100%, but still some of the countries are above the benchmark (Bulgaria, Croatia). On the other hand, some international institutions assess (IMF, for example) that the level of debt of the private sector in the region is currently high and not in line with its fundamentals. In addition, given that the debt of the private sector, in one part was financed through external sources, this process has had consequences for the rising external vulnerability of the region.

Even though the changes in the debt in the post-crisis period are small, the rapid growth of debt before the crisis still represents a burden on the external position. Hence, the deleveraging of the private sector in the next period might be inevitable, and given the debt-growth nexus, this process could be a potential impediment to growth. The impact might be even reinforced, given the anemic external environment, the narrow policy space, and some bottlenecks in the banking system, the burden of NPL's in particular.

If all the previously discussed issues are to be put in the growth context, it seems that more vigilant drivers should be found in the structural area, thus leading to rising productivity and competiveness. In that respect, it would be of interest to do a snapshot on the productivity data across the board. As productivity is a longer-term issue, we also deploy a longer-term perspective. At the same time, relative productivity is quite important for getting a more clear perspective to see how distant the region is, compared to a certain benchmark. As Germany is considered a good yardstick in this respect, we calculate the relative productivity of the region against Germany. Although the process of catching up in productivity in relation to Germany broadly continued, the speed significantly decelerated in the post-crisis period and currently, the productivity for the region as a whole accounts for about 62% of the German productivity. More favorable developments can be observed in Baltics, where internal devaluation process took place, and hence productivity improved mildly. Similar conclusion can be drawn by observing the data based on the growth accounting. By decomposing the GDP to contribution of the classical measured inputs, labor and capital, and the Total Factor Productivity (TFP), one can draw several inferences. First, before the global crisis, the TFP, which should be a vague indication of the efficiency and the technological growth, similar to Germany, was an important growth driver for the CEE and Baltic States, but less for the SEE countries, where the capital impact was prevailing. At the first stage of the crisis, TFP fell across the board. Subsequently, recovery was seen in all countries, but it was only the Baltics, similar to Germany, that benefited from the positive TFP impact. It is another facet, which gives an indication that the faster recovery of the region will require overcoming of many structural bottlenecks, thus boosting technological profile of the region, its efficiency and competiveness.

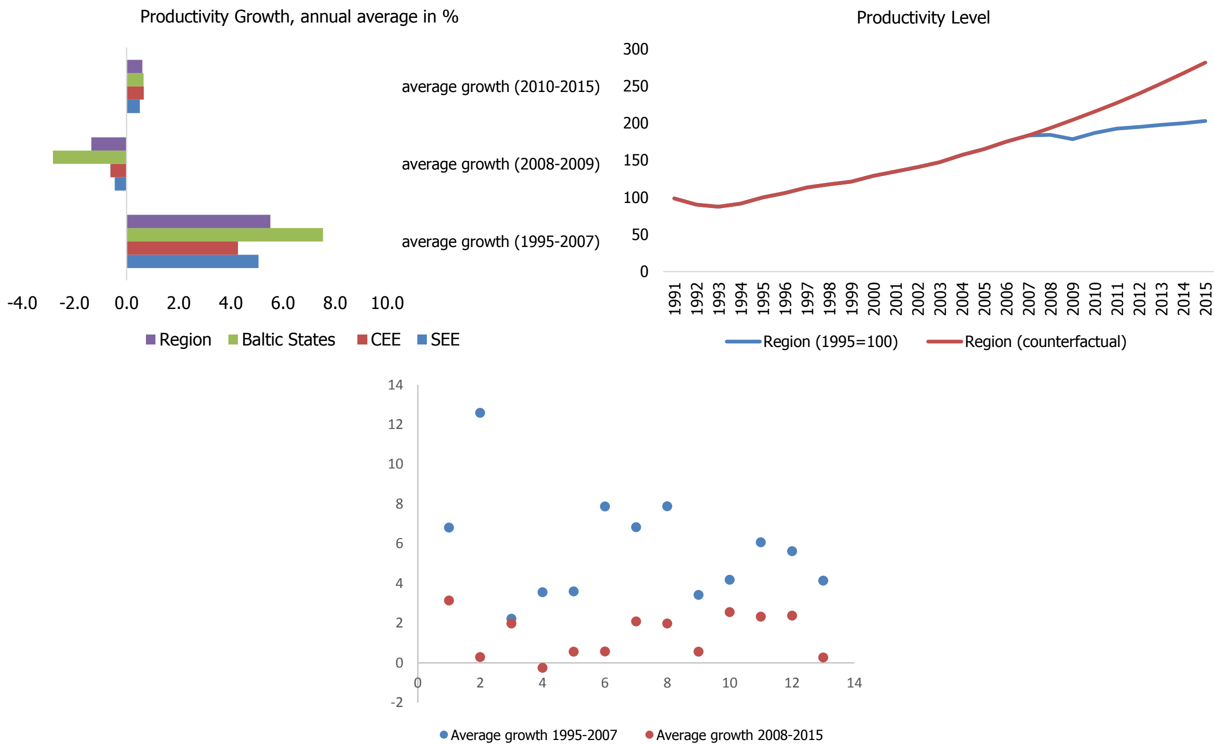
Chart 8: Productivity in the region, relative to Germany (ratio) and growth accounting



Source: The Conference Board. 2015. The Conference Board Total Economy Database™, May 2015, http://www.conference-board.org/data/economydatabase/. Authors' calculations.

If we run the same counterfactual simulation, as the one for the GDP, by applying the pre-crisis average growth to the 2007 productivity level, we observe again much higher productivity level compared to the actual one. It indicates the spare capacities in the region, and gone productivity opportunities. Given that the loss in productivity is very similar to the loss in the output, this also pinpoints certain structural deficiencies in the region, as the counterfactual loss indicates only slow employment adjustment, and potential weaknesses on the labor market. The observation of the productivity dynamics across the countries in the region shows that all of the countries in the region are going through a productivity growth slowdown (Chart 9, panel 3). On average, the slowdown gravitates around 4 p.p, with only few outliers, i.e. the BIH and Estonia where the slowdown is more pronounced.

Chart 9: Productivity from different angles

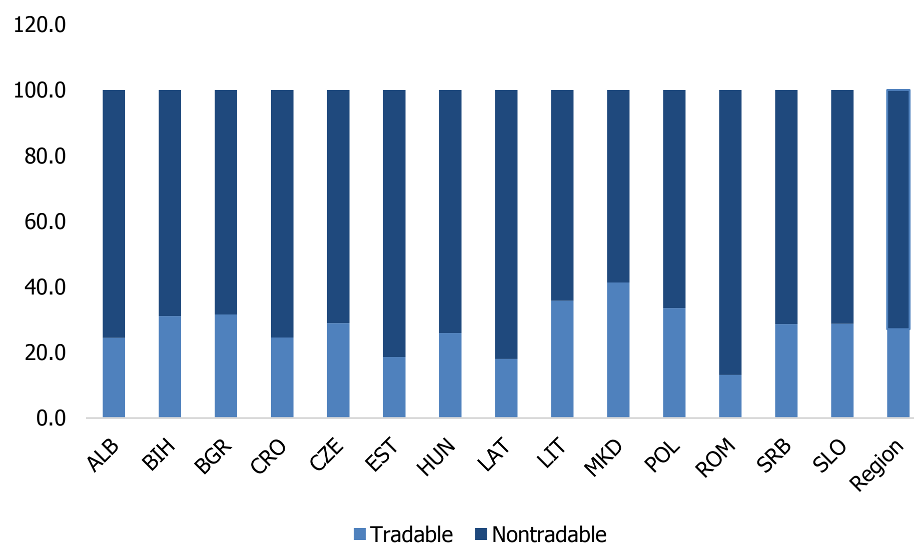


Source: The Conference Board. 2015. The Conference Board Total Economy Database™, May 2015, http://www.conference-board.org/data/economydatabase/. Authors' calculations.

The need to boost productivity brings us to another important issue for the region, which is the need to boost investment and increase the potential to grow. It is quite difficult task, given the current global economic circumstances, but it is unavoidable path if the growth is to become livelier. Traditionally, foreign investments have been a crucial source of additional capital in the region, which not only supplemented investments, but also provided boost to productivity and competitiveness to the regional economies. Fortunately, it is a source of inflows in the region, which was not completely discouraged by the burst of the crisis. Yet, particularly for the SEE group of countries that are lagging behind, FDIs remain an important challenge, if further rise in the economic potential is to be seen. Hence, again we are at a juncture where important issues in the growth context must reappear. First, the business environment in the countries must be friendly and competitive enough to attract financial flows. Second, financial flows should be allocated to productive, tradable sectors, thus boosting the growth of export. In other words, if another expansionary financial cycle occurs, a great deal of effort should be taken to ensure a proper allocation of resources, thus enabling rise in productivity and competitiveness. Historical data on inward FDI in the region point to a state where around two thirds of the inflows went to the non-tradable sectors, suggesting room for improvement in this area. Third, the strategy for tighter

integration in the global supply chains, that has been an important growth driver for many CEE countries, might be a good solution forward for some of the countries that are lagging behind in this respect.

Chart 10: Inward Foreign Direct Investment (structure in % of total)



Source: WIIW database. Cumulative inflows a sum of the annual inflows, data is not balanced, starting point different for different countries, conditioned on the data availability. Tradable includes agriculture and production. Non-tradable includes construction and services.

In summary, policymakers will remain faced with the challenges to revive the growth and speed up the convergence process. Despite some differences across countries, broadly, the policy space has been used up, to a great extent implying limitations on the further fiscal and monetary policy support. In most of the countries, the process of dealing with crisis legacies such as high NPLs and balance sheet repairing is not yet over and will continue to be a drag on the credit flows and on the short-term growth. External environment is expected to remain fragile and uncertain, particularly in light of the possible slowdown of the emerging markets with possible negative spillovers through the real and financial channel, geopolitical risks as well as the ongoing refugee crisis in Europe. The countries where the recovery has progressed will have room to shift the focus from short-term stabilization of aggregate demand to medium-term structural issues that will increase the long-term potential of the economies, as well as rebuild internal and external buffers.

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