National Bank of the Republic of North Macedonia

Steering Policies in Times of Great Volatility

9th ERSTE Investors' Breakfast

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Setting the Stage - **Context**

- The **post pandemic recovery interrupted** by the war in Ukraine at the beginning of the year

- The new crisis aggravated the pandemic induced weaknesses – **elevated uncertainty, slowed and fragmented supply chains, rising input costs, disruption on the global food and energy market**

- The **economic damage** from the two subsequent shocks resulted into a coexistence of **growth slowdown** and **rapid acceleration of inflation** across the board

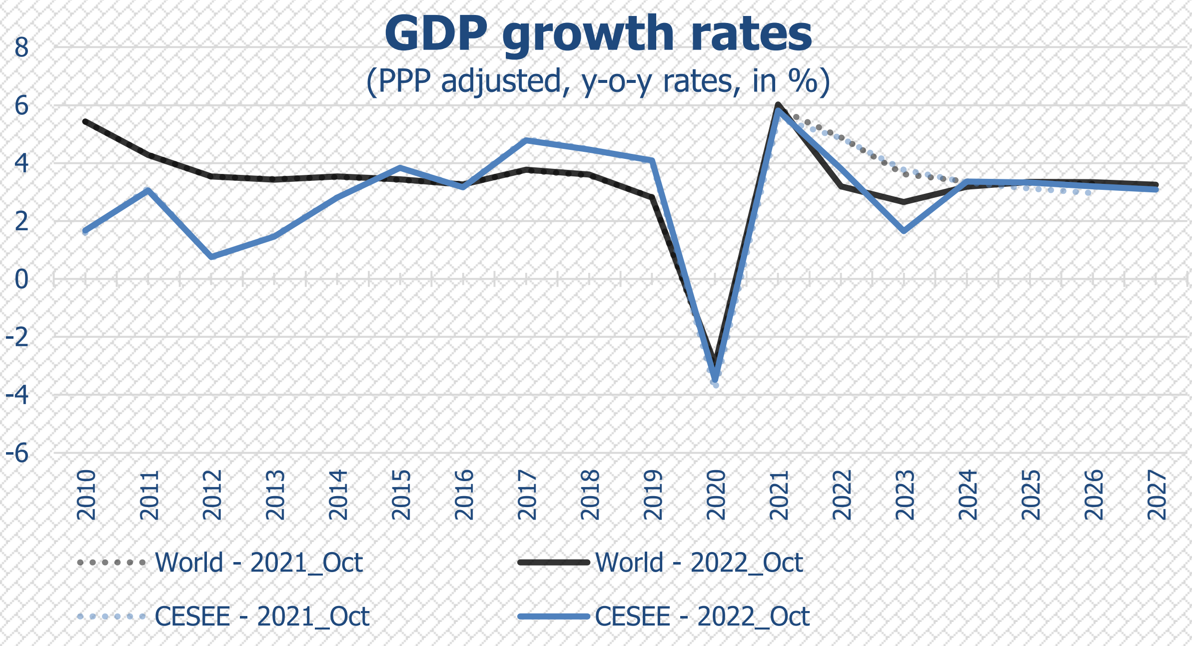
- **Policy space for supporting economies depleted** – rising deficits and debt constrain fiscal room for maneuver, while **monetary policy makers embarked on normalization** to curb inflation

Loss of the Global Economic Momentum

- **2021 – a year of tentative recovery** after the pandemic shock

- **The recovery interrupted by the war in Ukraine –** rising prices are slashing **real income, confidence** is plunging, **global financial conditions are tightening**

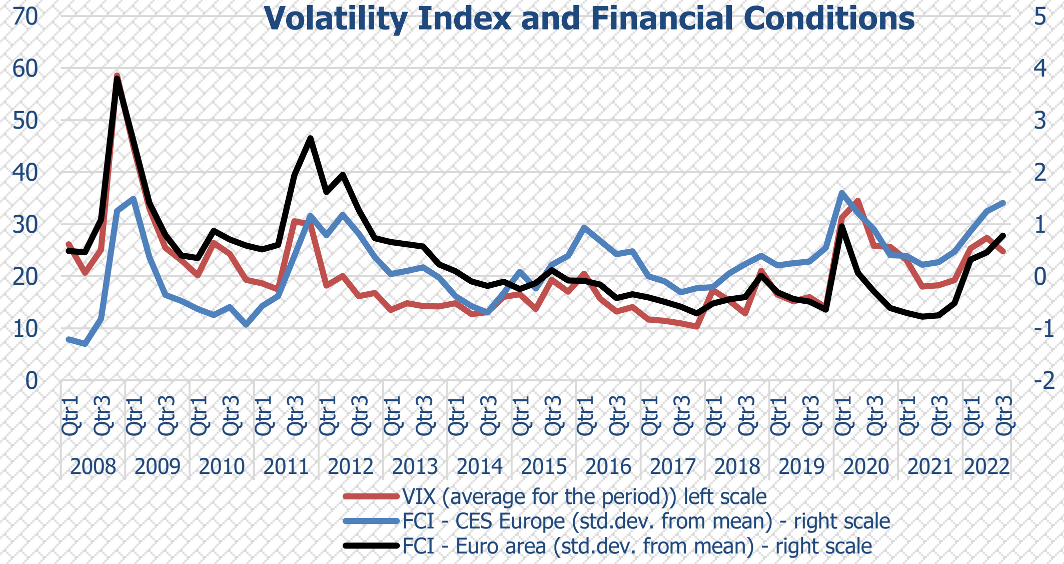
- **Economic outlook –** forecasts are trimmed across the board, for Europe in particular

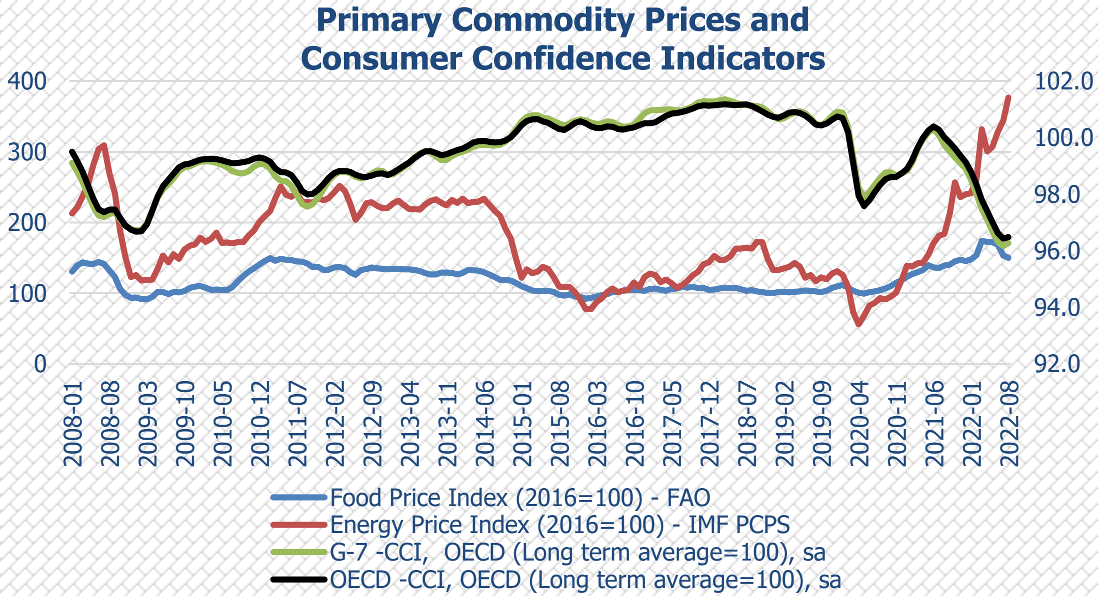


Source: IMF WEO Reports

Drivers Shaping the Conjuncture

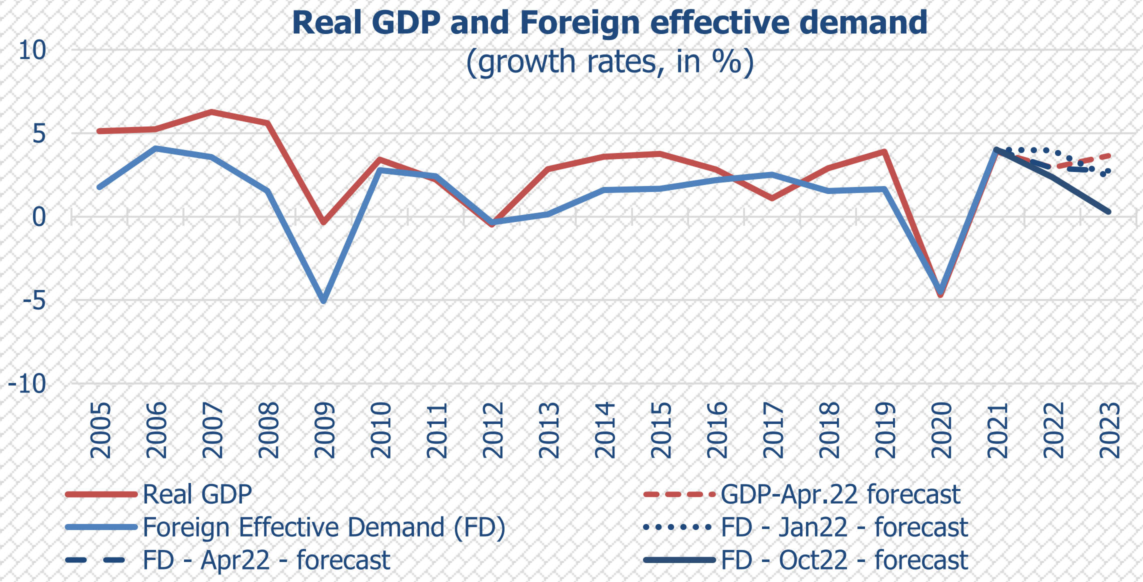
- **Elevated volatility on the financial markets**
- **Tightening of global financial conditions**
- **Plummeting consumer confidence, with some of the indicators showing lower levels compared to the pandemic**
- **Severe impact on prices of primary commodities and global inflation**

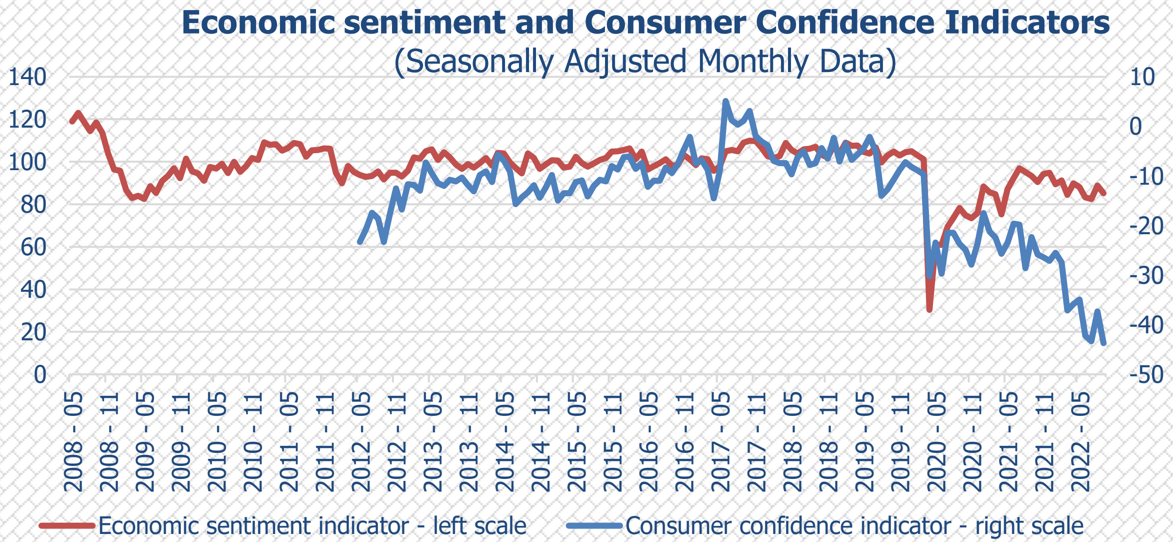




Macedonian Economy in a Volatile External Context

- **Direct economic impact** from the latest geopolitical tensions – limited, both through trade and financial channel
- **Indirect impact –** visible through several channels
- **Slowdown in foreign effective demand and downward revision of its outlook –** growth unconducive global environment
- Drop in **confidence** and **risk appetite** – expected amid unprecedented global uncertainty
- **Strong pressures on domestic inflation** – the large share of imported components in the total CPI aggravating pressures
- **Remittances –** commonly an important channel through which shocks are transmittedd **-remained resistant and robust,** supporting balance of payments and disposable income



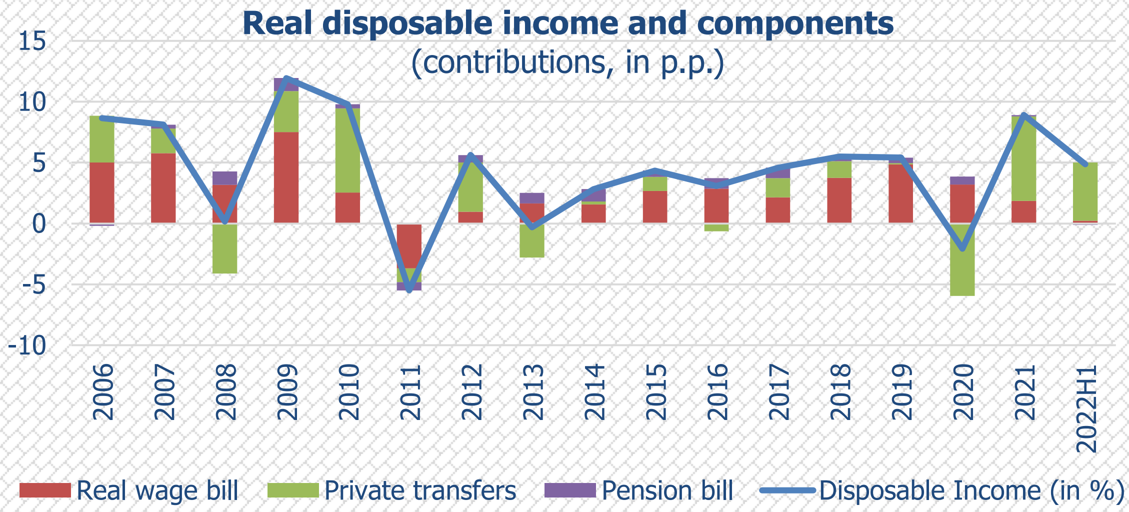


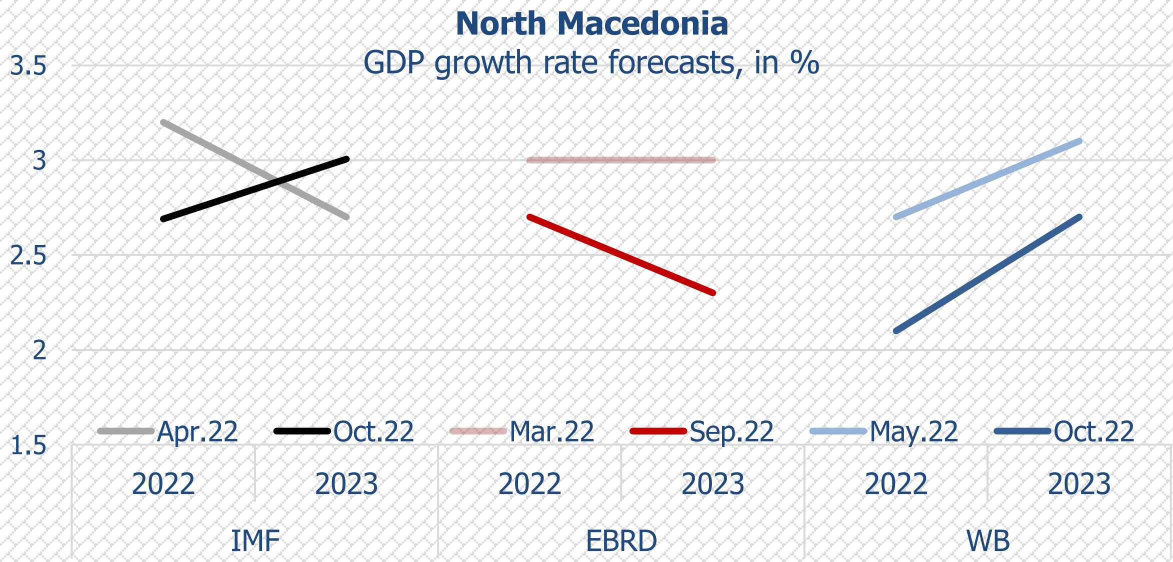
Slashed Economic Outlook on the Backdrop of the latest Crisis

- Given the unfavorable external environment **GDP outlook slashed** during the spring forecast vintage

- As the crisis was evolving, creating **unprecedented pressures on the energy sector**, the outlook deteriorated further

- Despite downward corrections, risks remain predominantly on the downside





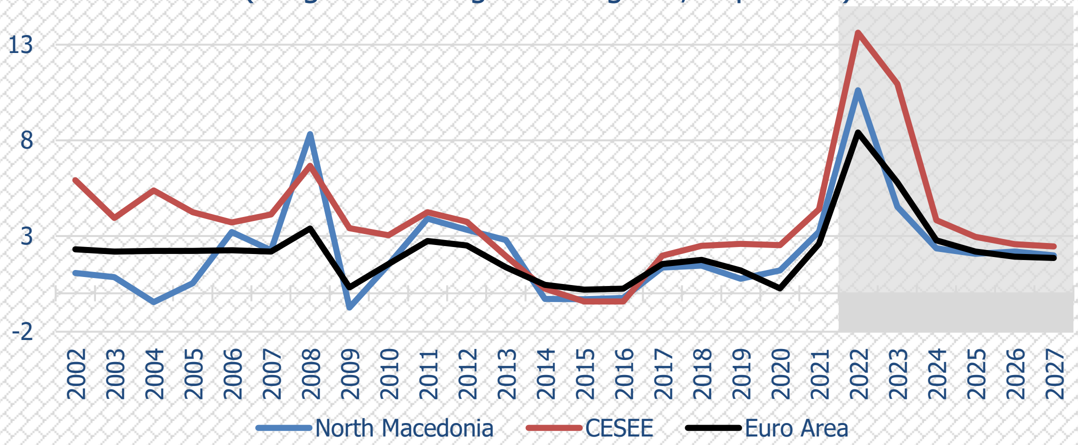
The Great Return of Inflation?

- Despite the incomplete recovery, **the acceleration of inflation**, globally and for the region started already in the middle of 2021

- **Initially, the rise in prices limited to a smaller number of products,** mostly related to supply – demand pandemic disruptions, noted as transitory

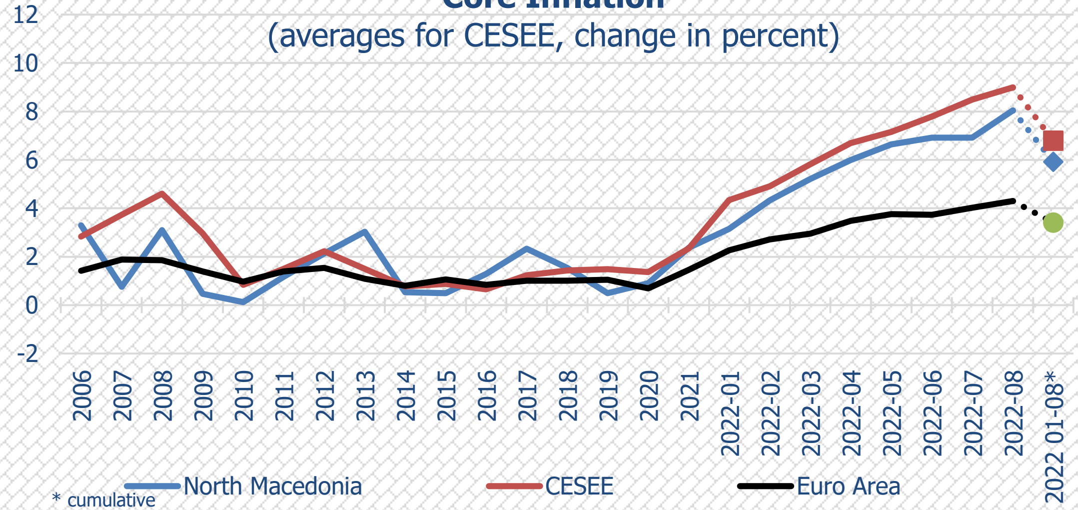
- **Broader – based increase**, by the end of 2021 and in the course of 2022

Annual CPI Inflation
(weighted averages for regions, in percent)



Source: IMF WEO Oct 2022 database and own calculations.

Core Inflation
(averages for CESEE, change in percent)

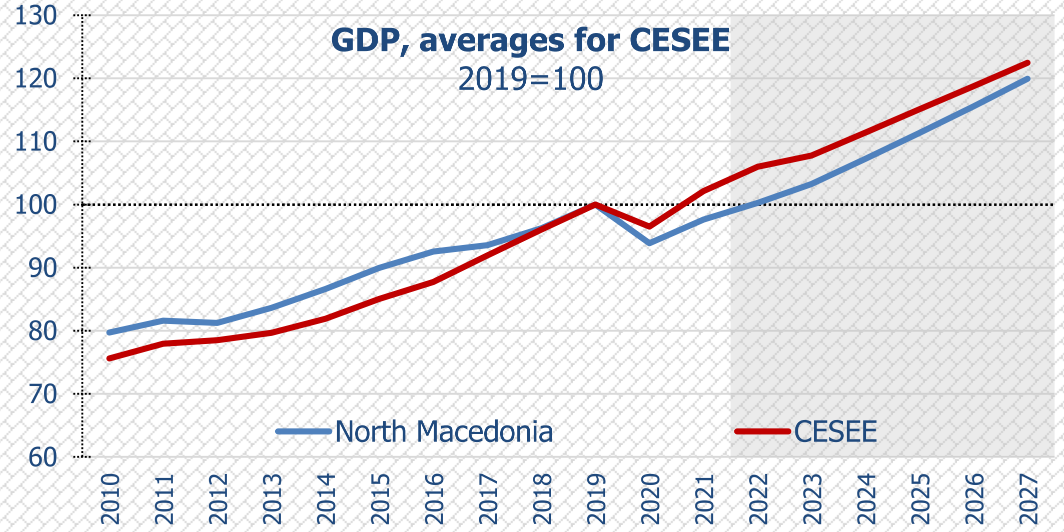


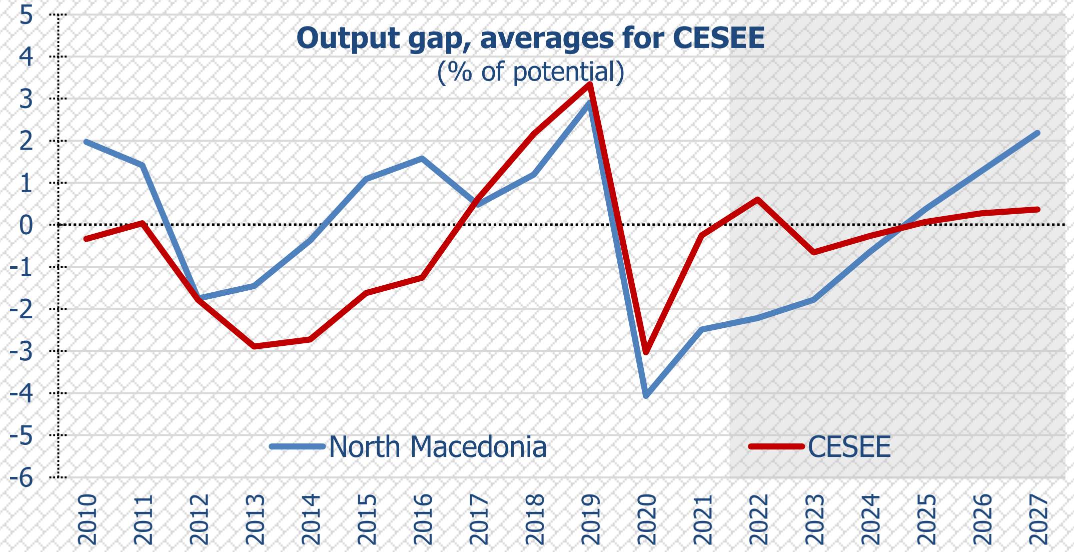
Source: Eurostat and National Statistical Agencies.

The Root Causes of Inflation

- **No signs of overheating** but **slowly adjusting supply** to recovering demand created mismatches that spurred prices

- **The adjustment of energy and food prices -** prolonged rise, driven by energy transition process, supply deficiencies and the abrupt and strong impact on commodities prices caused by the war in Ukraine





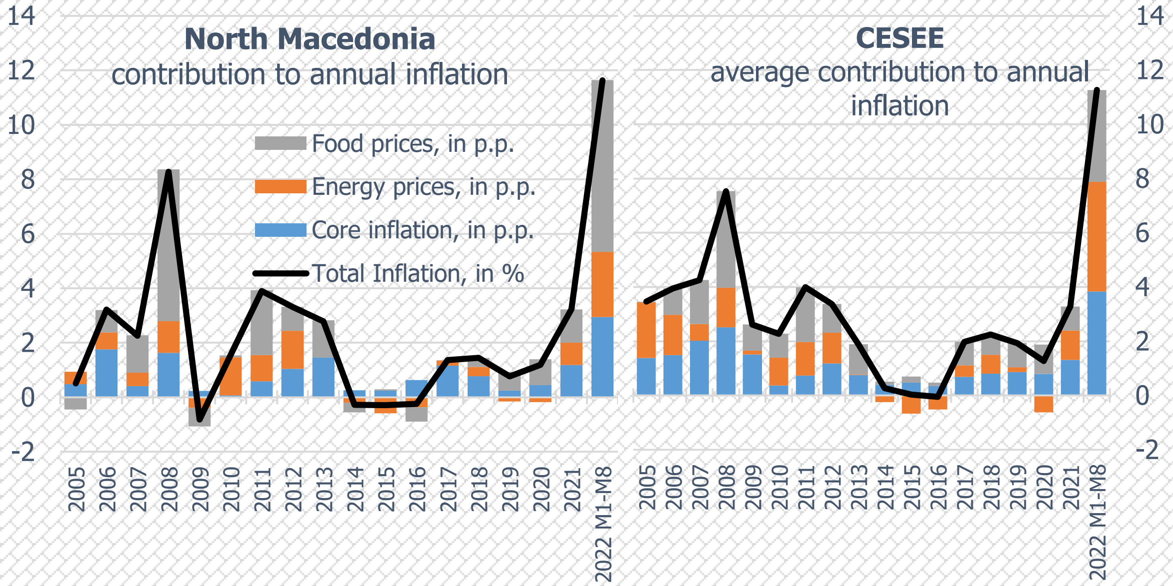
Sources: IMF WEO Database and NBRNM staff calculations (Oct 2022)

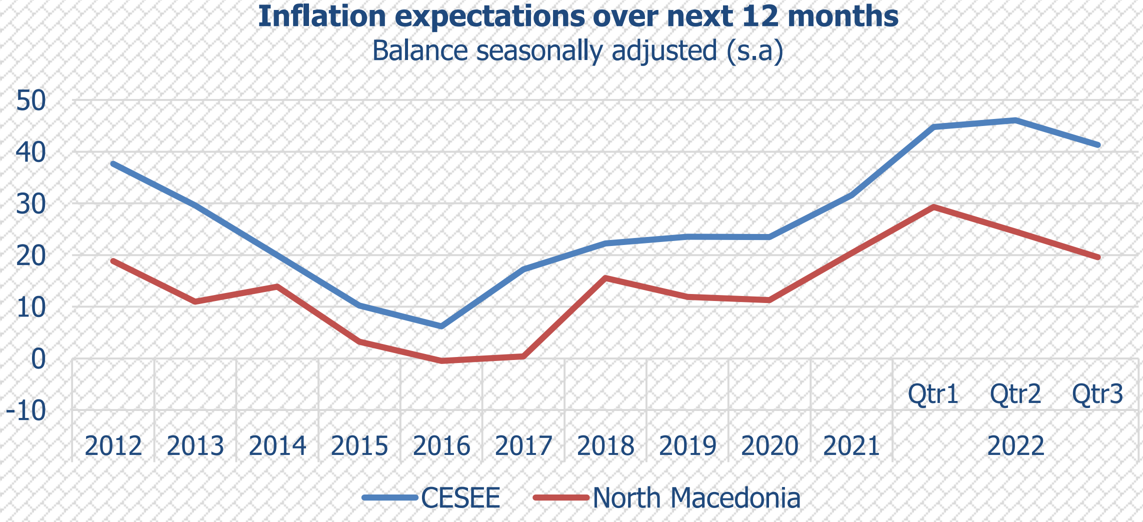
The Root Causes of Inflation

- **Intense dynamics of the global energy and food prices -** the percentage explained by these two components equaled 70%, compared to an average of 50% in the previous three years.

- Persistent and protracted rise in the energy and food prices **led to more intensive second round effects** and acceleration of the core inflation and inflation expectations

- Small, open economies, energy intensive **highly exposed to commodities shock**





Source: EC Consumer and Business Tendencies Surveys.

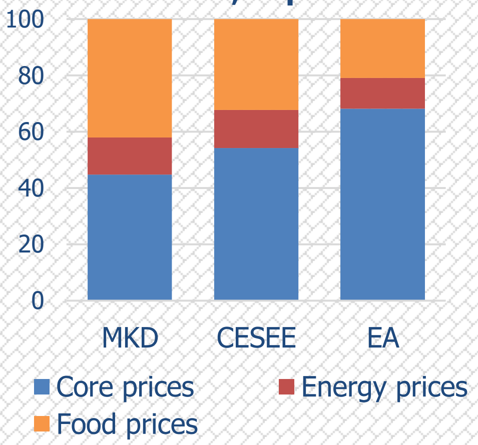
Macedonian Case

- Given **the large trade openness**, the extraordinary shocks to the import prices led to acceleration of Macedonian inflation, as well
- The **larger share of food and energy prices, and the overall energy intensity** compared to the more advanced economies created comparatively stronger pressures
- As elsewhere, rise in prices became broader - based, and it was not limited to goods only, but services as well, rising the risks of a more persistent inflation pressures
- Yet, our analytical scrutiny reveals that **most of the inflation dynamics is explained by imported components,** while the so called domestic inflation has minor impact on the total inflation

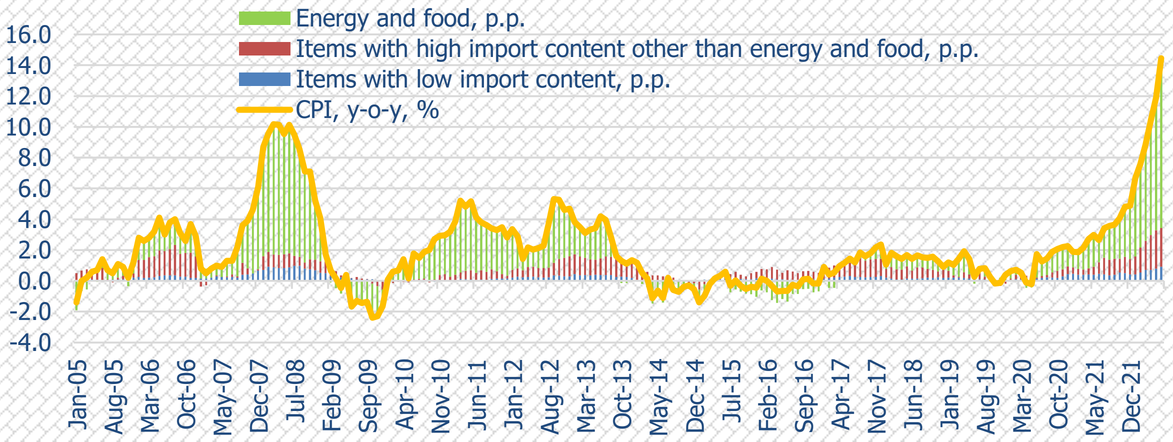
	<0	[0,2)	[2,5]	(5,10]	>10
2018	33	42	7	8	10
2019	41	29	14	13	3
2020	18	42	18	15	7
2021	8	33	31	14	15
2022m1-8	4	13	8	27	48

Source: Eurostat and NBRNM staff calculations.

Structure, in percent



Decomposition of headline inflation rate, y-o-y
(contributions in p.p.)



Sources: Eurostat, National Statistical Agencies, NBRNM staff calculations, Ramadani G., Andonova Unevska D., 2022

Central Bank Response to the New Context

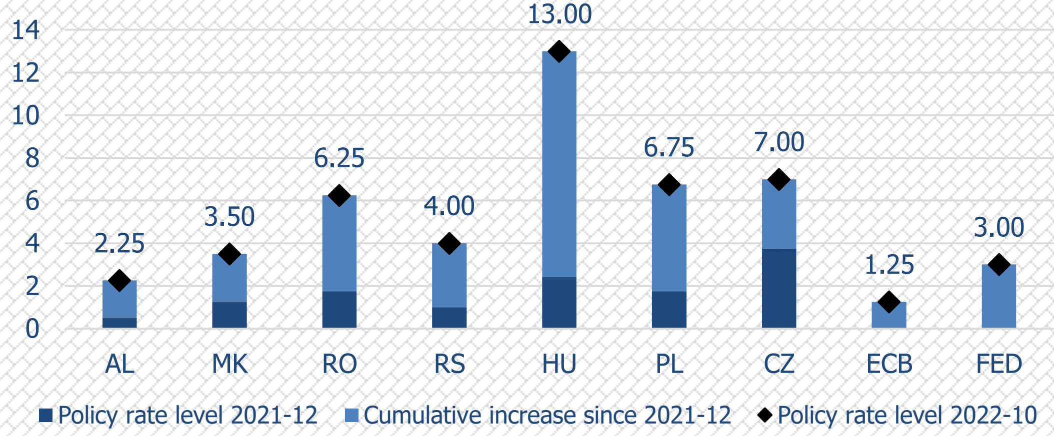
- Central banks are dealing with a **delicate and unconventional** circumstances

- Demand pressures do not prevail, and severe risks weigh on the recovery process, yet the inflation became more persistent and broad based (**conflicting data and trends**)

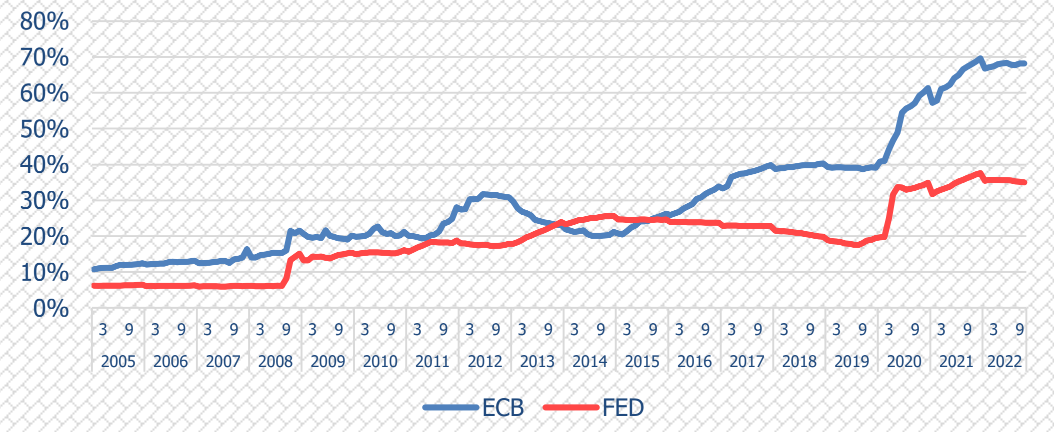
- The shift towards a "new regime" prompted almost all of the central banks to embark on monetary policy tightening. **The monetary policy cycle is now increasingly synchronized around the world**

- Some central banks have begun to reduce the size of their balance sheets, moving further towards normalization of policy (FED for instance)

Key Policy Rates

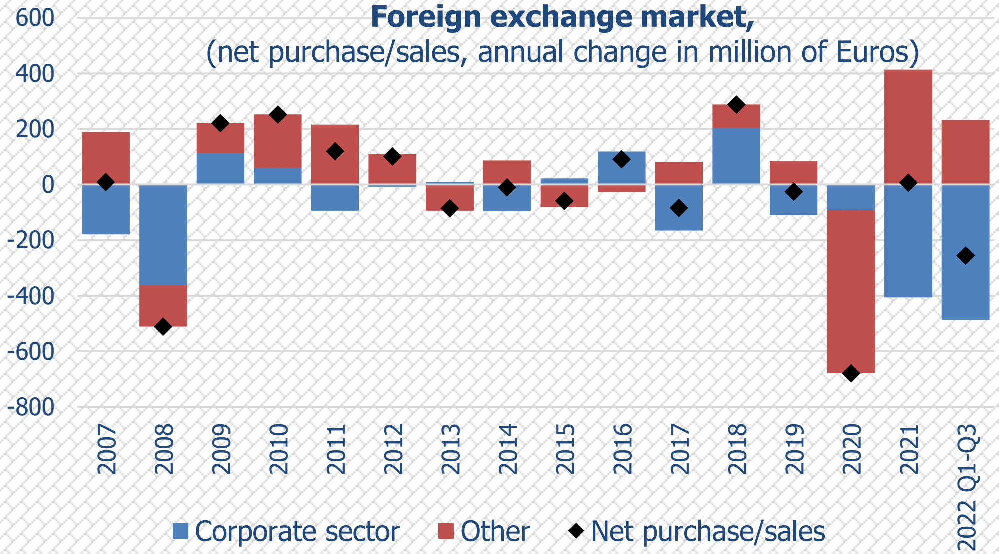


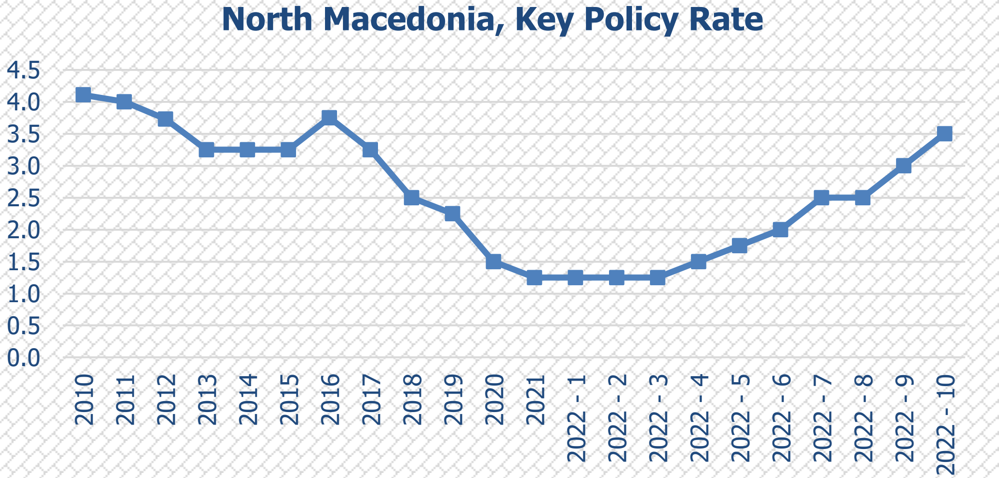
Total Assets of ECB and FED
(% of GDP)



Macedonian Case – Specifics when running a Peg

- The volatile environment and the energy crisis created **pressures on the foreign exchange market**
- Since the end of 2021, the central bank **has been withdrawing liquidity** through forex interventions
- The **level of gross reserves remains adequate to sustain the peg**
- **Tightening cycle through interest rate rise** started in April 2022 with cumulative increase of 2.25 p.p.
- Changes to the **reserve requirement system** – to facilitate denarisation and to stimulate investments in renewable energies



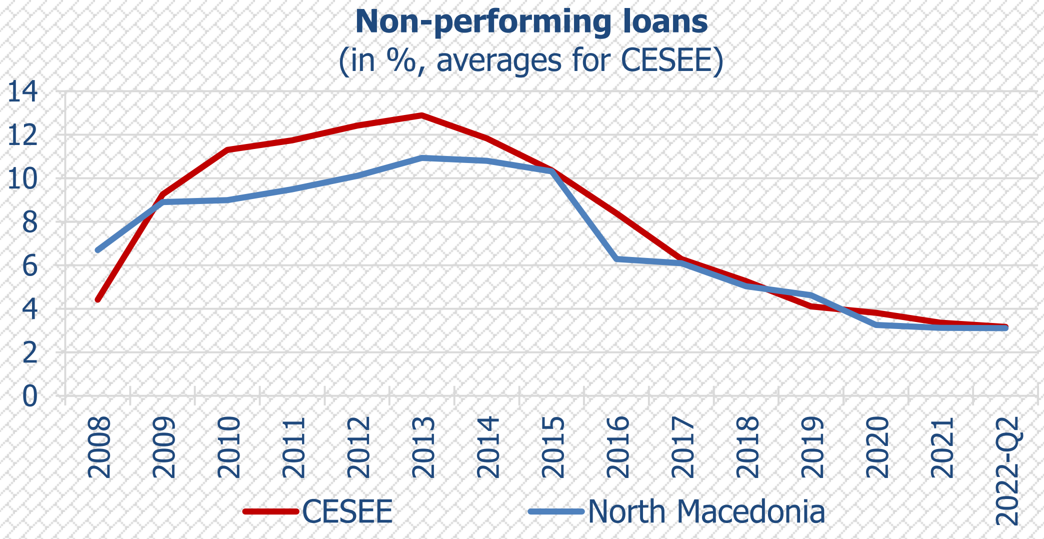


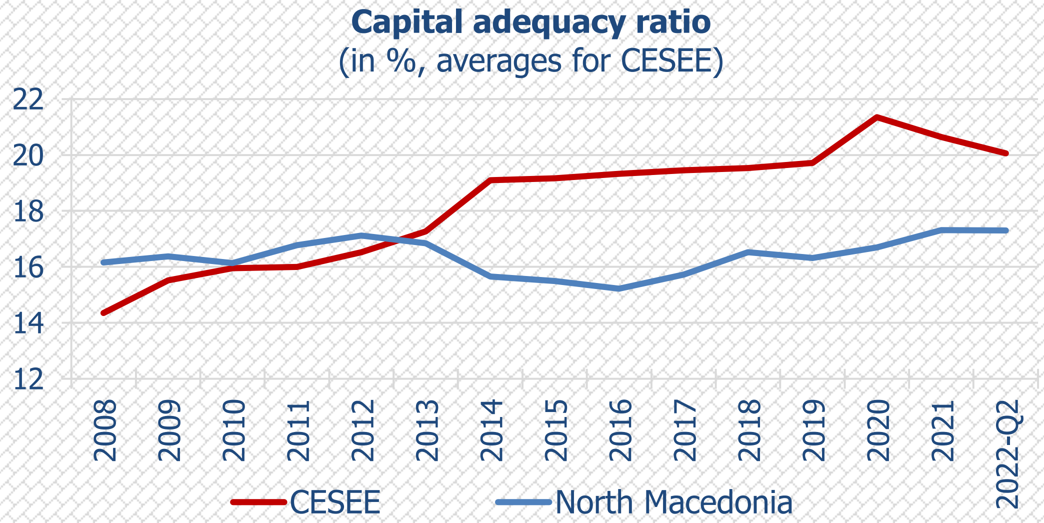
How far should we go?

- The tightening path is clear, but no **“one-size fits all” solution** in the sequencing, as many country specifics are in play
- Central banks with **tough choices to curb inflation, while limiting the pro-cyclical impact** on growth and adverse impact on **financial stability**
- More **gradual data-driven approach**, **preferable** in times of high uncertainty, supply driven shocks to inflation and worrisome economic outlook
- For the major central banks, **market participants expecting moderate hikes until the end of next year**

Financial Stability Considerations

- **Main risks** – with the prolonged crisis and uncertain recovery, problems in the real sector can spill over to banks and deteriorate the quality of credit portfolio
- …**sudden and large swings in interest rates** can overburden the debt service, when variable interest rates credits are used (70% of total credits in the Macedonian case)
- **So far risks are well contained – NPLs are low and falling**, enhancing the capacity to withstand unexpected shocks
- **Solvency ratios,** as a main indicator for the capacity to absorb shocks, remain strong
- Yet, given the overall uncertainty **vigilance** is needed
- The recent **stress test scenario analysis** for 2022 and 2023 confirms the overall resilience of the banking system on macroeconomic shocks





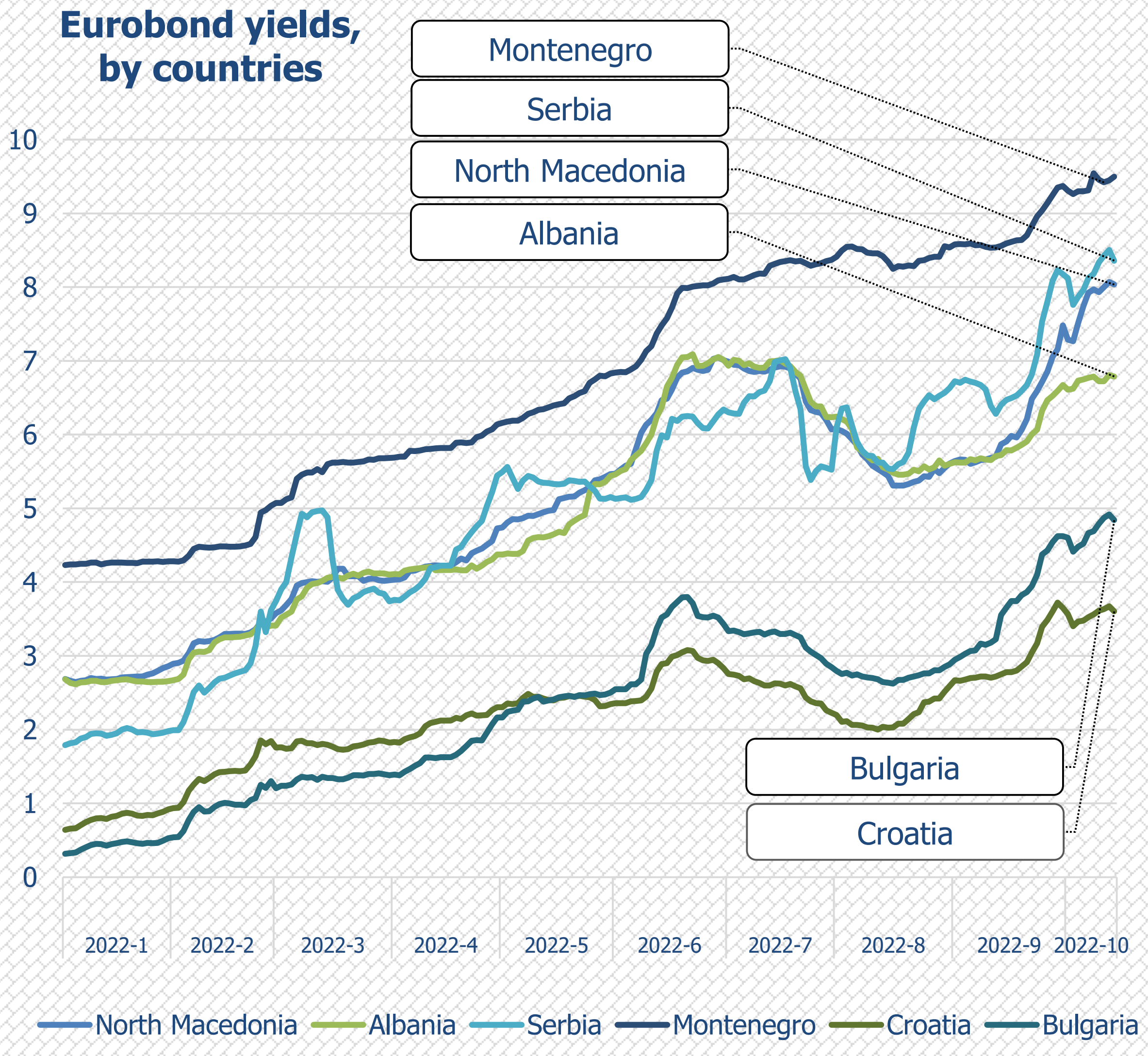
Source: World Bank, IMF, National Central Banks and own calculations.

Monetary- Fiscal Coordination – a necessity

- **Tightening of global financial conditions –** makes access to finance more difficult …

- **…**and hence fiscal policy has to remain **prudent,** while at the same time having **proactive role,** alleviating the burden on the most vulnerable, through **targeted and temporary measures**

- **"Smart" consolidation must** be in **place –** to have fiscal finances in check, retaining the confidence of investors, while cushioning the impact of the current shocks for those in need



Conclusion

- **Policy makers are in the midstream of tectonic shifts** in geopolitical and economic terms

- **Monetary policy will remain focused on curbing inflation –** undertaking necessary measures and effectively communicating our stance and the rationale behind it

- **Fiscal policy –** targeted support, while rebuilding policy space

- "We should also accept the reality that if we want to have resilient, accelerated and sustainable economic growth in the future, with more opportunities for everyone, we need to depend less on the healing powers of fiscal and monetary policies" (Carstens, BIS, 2022)

- Hence, there is much on **a structural front** to be done in order to alleviate current pressures