How to Tame Inflation without Undermining Financial Stability and without Causing Hard Landing?

Challenges for Central Banks

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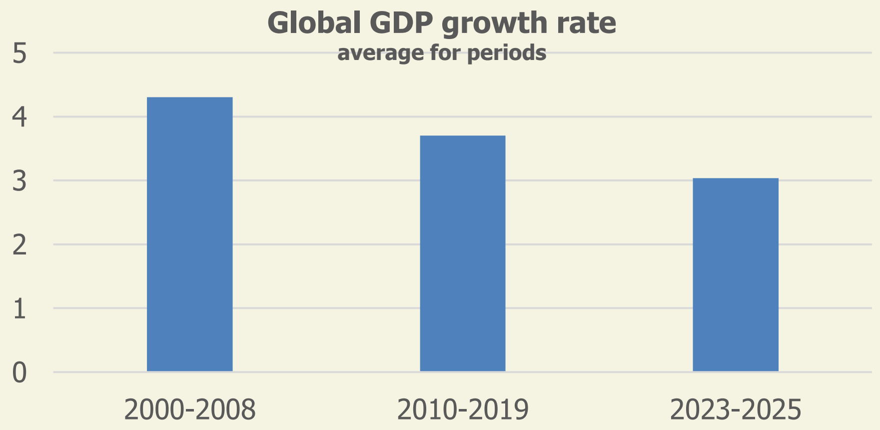
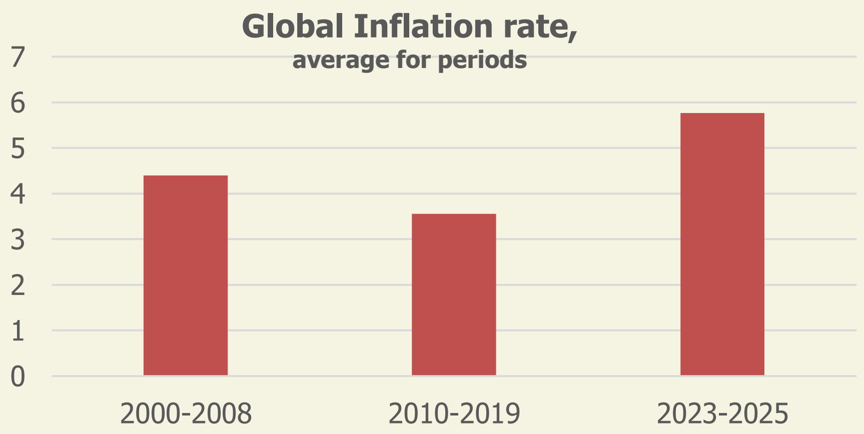
Unprecedented global stress

- **Recent series of shocks have been one of the greatest stress tests** that our economic and financial systems have faced in recent history
- On the one hand, we are faced with **depressed growth prospects** (reflecting structural and cyclical factors) - medium-term global growth of about 3%, which is well below the historical average of two decades preceding the pandemics...
- …on the other hand, **still high inflation**, which although on a downward trajectory, is projected to remain above target in about 90% of the economies even next year…
- …. furthermore, this is taking place in environment of **elevated risks in financial systems**, as evidenced by recent developments in the US and Switzerland
- *This environment creates* ***huge challenges in adequately calibrating macroeconomic policies*** *to deal with permanently changing economic relationships, implying that we might be entering a new world rather than returning to the old one*



Source: IMF WEO October 2023

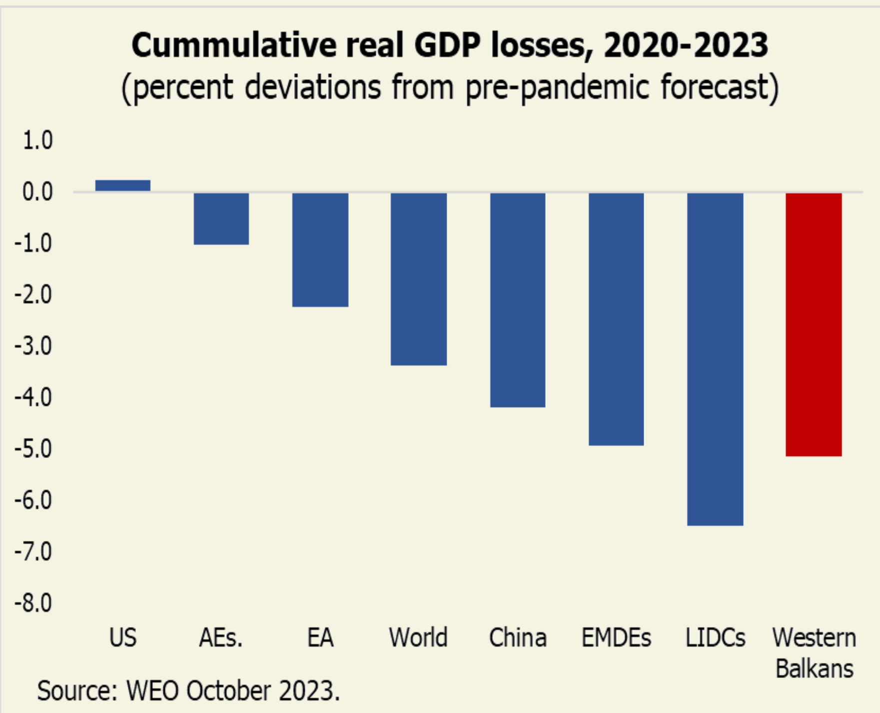


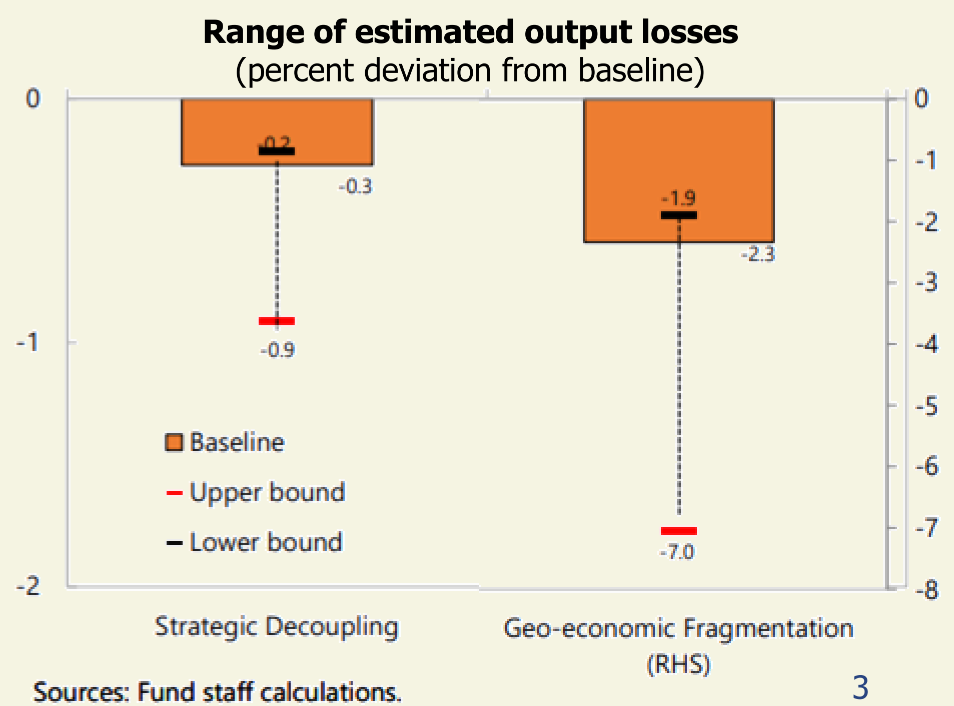
Source: IMF WEO October 2023

Global economy is recuperating, but slowly, with many risks ahead

- **Output loss so far has been large -** global GDP in the last 4 years was lower by 3.5 p.p. in comparison with pre-pandemic forecasts, and in emerging market economies, including Western Balkan, the loss is even bigger (5 p.p. and 4 p.p. of GDP, respectively)

- **Looking forward, losses may be even more pronounced as geo-economic fragmentation** could trim the global GDP by additional 1.9% to 7%, depending on the severity, the spill-over channels and measures undertaken for resilience. The most extreme scenario goes up to 12%, assuming combined effect of trade and technological decoupling (Goes and Bekkers, 2022)





The cost of geo-economic fragmentation can be particularly high for small and open economies, such as WB economies

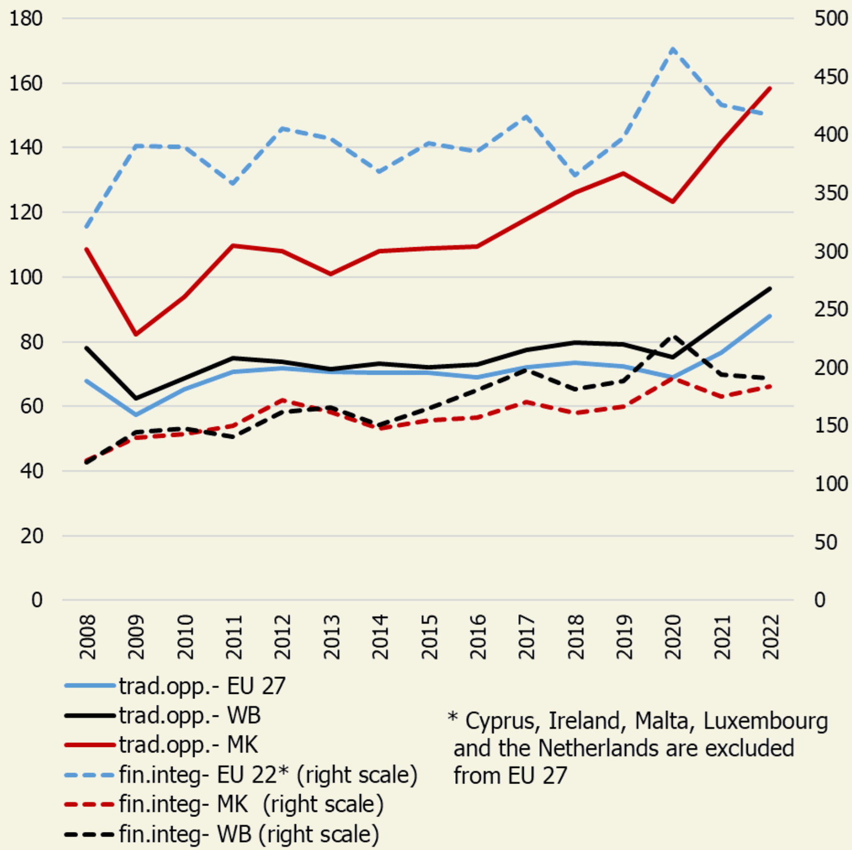
- In the past two decades, **globalization has been the main "engine"** for faster trade and financial integration, which contributed to income convergence of the region

- **Trade integration** in WB has increased significantly, reaching around 100% of GDP in 2022. Macedonian economy is the front runner with 160% of GDP

- **Financial integration** has also increased, close to 200% of GDP
  - Significant part through FDIs in the tradable sector, which meant diffusion of knowledge and technology

- The reversal of this beneficial process, if unaddressed with proper policies, can be **very costly.**

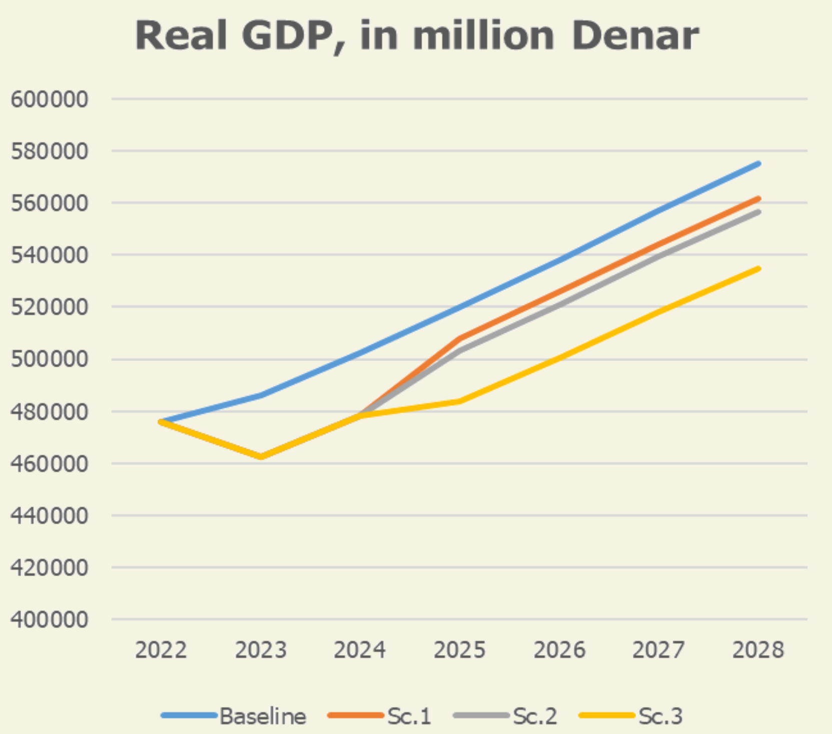
Trade and financial integration
(percent of GDP)



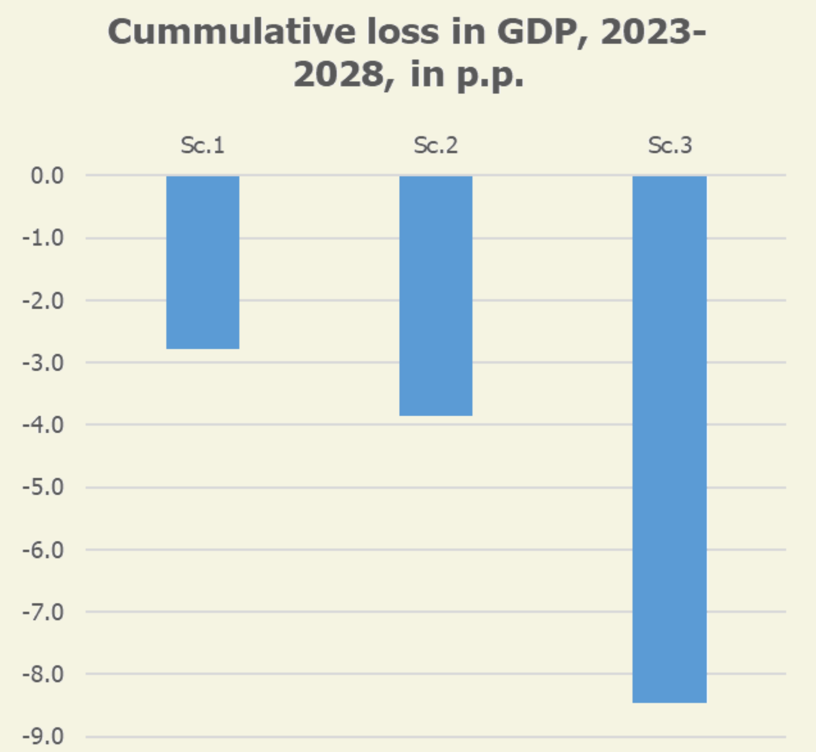
* Cyprus, Ireland, Malta, Luxembourg and the Netherlands are excluded from EU 27

Source: Eurostat, IMF, Central Banks and own calculations

Cost for the Macedonian economy can be sizable



Source: Own calculations.



Source: Own calculations.

- **Underlining a need for adequate policies** to cope with the risks, but also use opportunities such as nearshoring

Furthermore, global growth prospects can be disrupted by new turbulences - Israel-Hamas conflict

- **Some estimates** show that if the conflict evolves into a wider war in the Middle East (crucial supplier of energy and key shipping passageway), it could lead to financial market stress to levels not seen since the '90s, oil prices reaching 150$- feeding into higher global inflation (+1.2 p.p.) and lower growth (-1 p.p.)

Economic Impact of War

Global growth and inflation impact of three scenarios for how the Israel–Hamas conflict could evolve

Scenario	Details	Impact on oil prices and VIX*	Impact on global GDP and inflation**
Confined war	- Ground invasion of Gaza - Limited broader regional conflict - Lower Iranian crude output	Oil: +$4/barrel VIX: No impact	GDP: –0.1 ppts. Inflation: +0.1 ppts.
Proxy war	- Multifront war in Gaza, West Bank, Lebanon, Syria - Unrest in wider Middle East	Oil: +$8/barrel VIX: +8 points	GDP: –0.3 ppts. Inflation: +0.2 ppts.
Direct war	- Israel and Iran in direct conflict - Unrest in wider Middle East	Oil: +$64/barrel VIX: +16 points	GDP: –1.0 ppts. Inflation: +1.2 ppts.

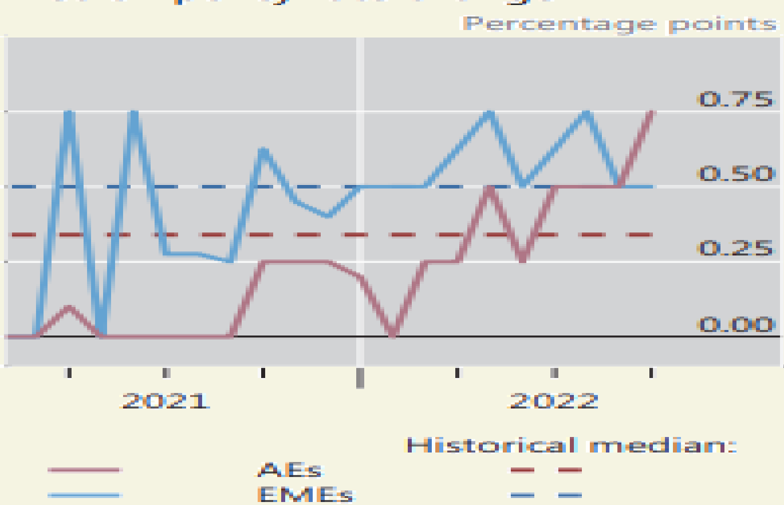
Source: Bloomberg Economics
*Impact calibrated based on 2014 Gaza War, 2006 Israel–Lebanon War, and 1990–1991 Gulf War.
**Impact on year on year change in global GDP and inflation for 2024, estimated using Bayesian Global VAR

In general, recent crisis has significantly depressed the growth prospects, but has led to historically high inflation

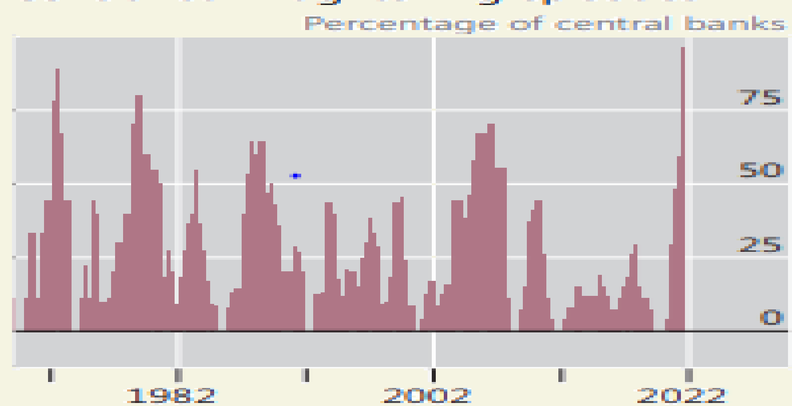
- **Last year global inflation surged to 8.7%** (in most of the emerging economies being in double digit territory - in our case 14.5%), the highest in the last 25 years.

- **Central banks have responded with the most synchronized and intensive policy tightening in the last 50 years**
  - it started by EM economies, followed by AE. By August 2022, 95% of central banks started tightening, while this percentage has rarely been above 50% before (with exception of great inflation period – ’70s - ’80s)
  - tightening was done through lifting policy rates (at about twice the historical pace) and lowering of liquidity
  - similarly, we started tightening MP in 2021 combining fx intervention, policy rate and RR, supported by macro prudential measures that reinforced monetary transmission

Median policy rate change



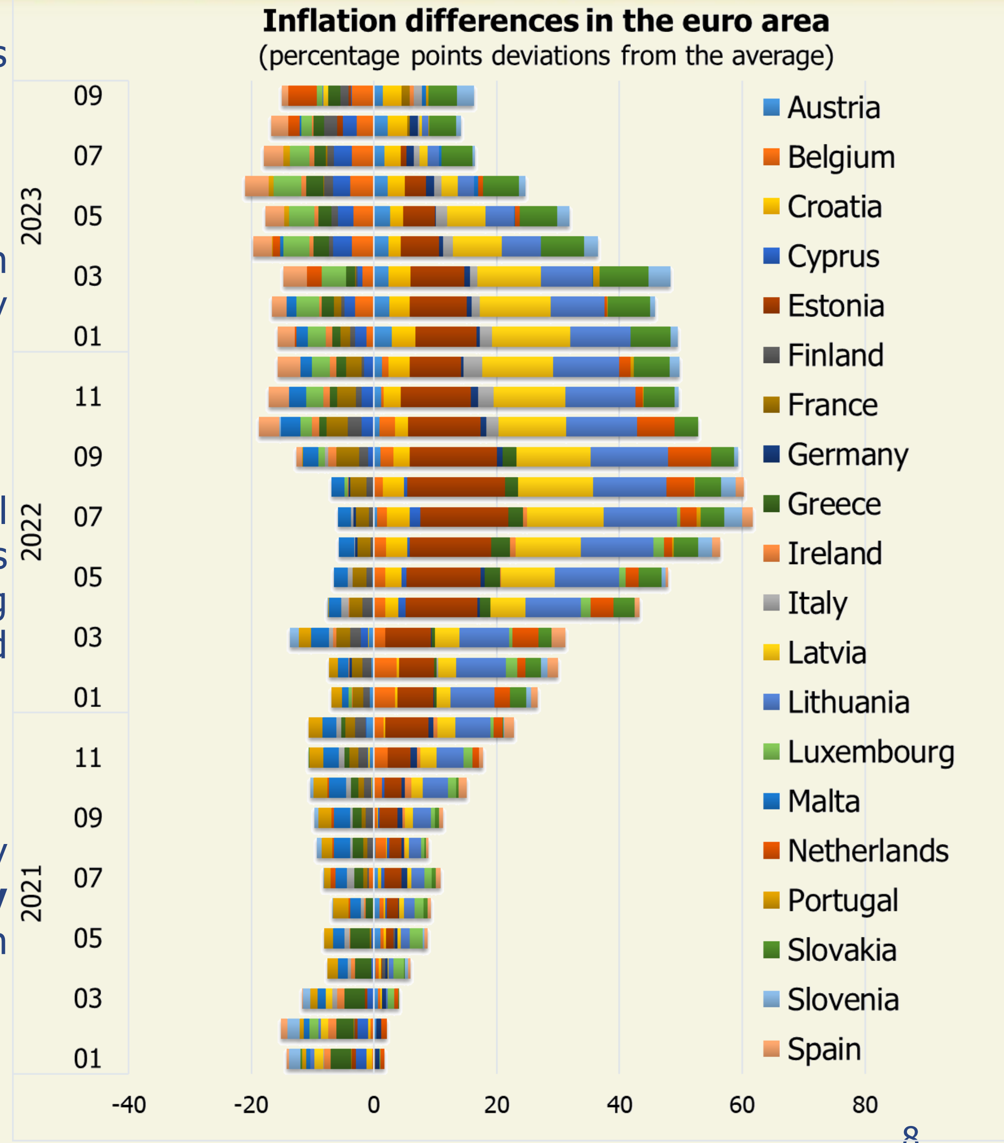
Central bank tightening episodes[2]



Source: BIS.

Strong MP tightening in combination with commodity prices and other policy measures have led to declining inflation, though with notable difference across countries

- Thus **inflation differentials** across countries remain…
- **Including in EA** (1% in Belgium to 9% in Slovakia) despite the common monetary policy….
- **Studies** attribute the difference to structural features of the economy, policy measures such as price caps, tax reductions, pricing power of companies / competition and tightness of the labor market…..
- ….clearly underling that current inflationary shock **is not a standard monetary phenomenon** that can be dealt only with standard monetary policy response….



Source: Eurostat and NBRNM calculations.

Domestic inflation is also decelerating and the pace is stronger than in the EU

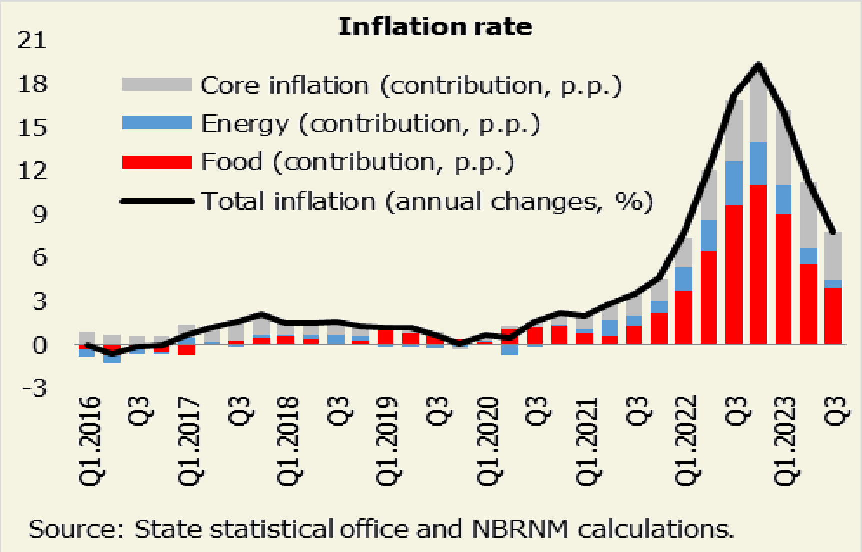
- **The peak of inflation was 19.8% y/y** in October last year (with direct contribution of food and energy by 75%)

- **Since then it has been coming down for 11 months in a row** and is now lower by 2/3 from the peak in October of last year - 6,6%

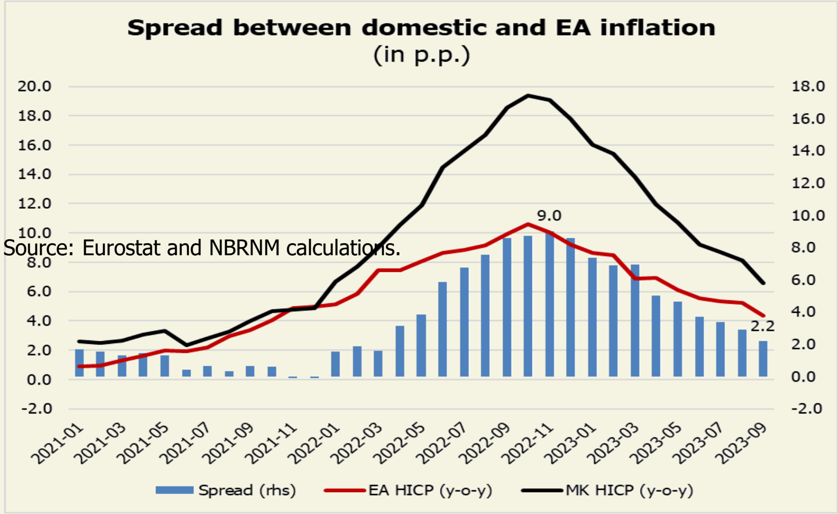
- **The pace of deceleration is stronger than in the EU -** the spread declined from 9 p.p. at the peak in 2022 to about 2 p.p. in September 2023

- Typically, **during the inflationary episodes driven by commodity shocks**, inflation differential with EU tends to increase, reflecting **structural factors** (high import dependence of food and energy, high energy intensity, and almost twice as higher share of food and energy in CPI), as well as **institutional factors** such as size and types of policy measures and level of competition

- Same shock is propagated with different intensity across countries depending on structural and institutional factors!



Source: State statistical office and NBRNM calculations.

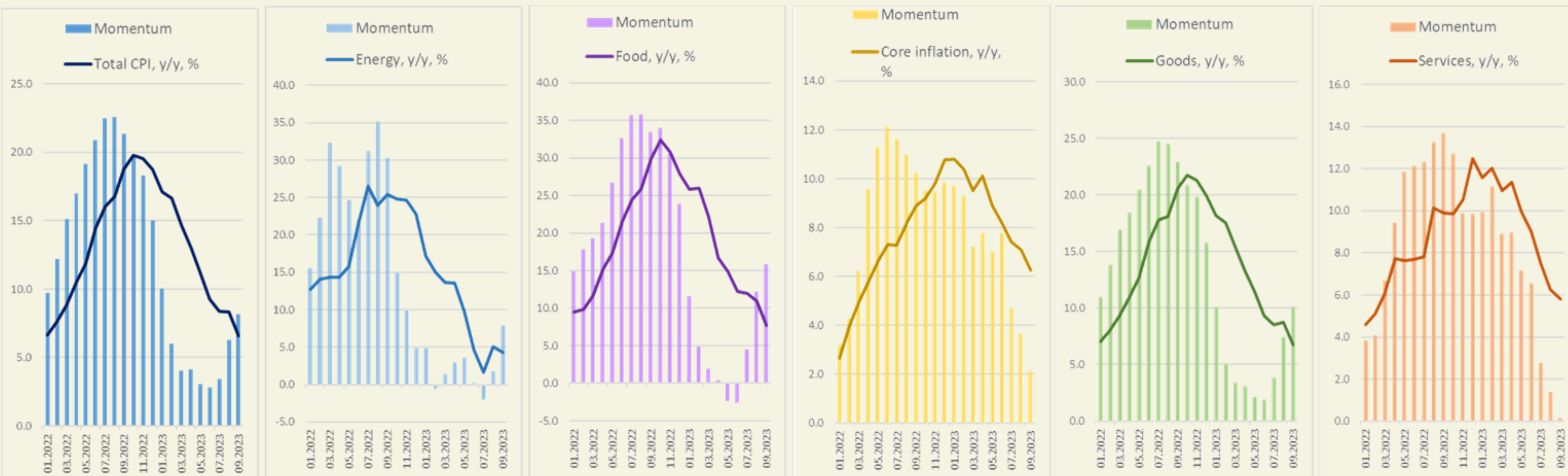


Source: Eurostat and NBRNM calculations.

The deceleration of inflation is particularly visible from indicators of inflation momentum

Inflation momentum

(annual percentage changes; annualized percentage changes)



Sources: SSO and NBRNM.

Notes: Momentum is defined as annualized 3 months on 3 months rates, seasonally adjusted data. Core inflation: CPI excluding energy and food.

Latest observation: September 2023.

Similar conclusion can be inferred by inflation heat map and inflationary expectations

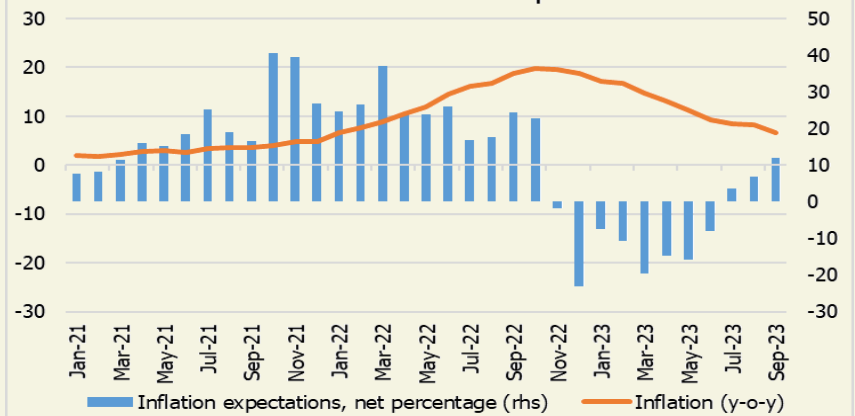
- **The share of CPI items with more than 10%** increase declined to 26%-down from 69% at the peak

- **And consumer inflation expectations are also down** from the elevated levels in 2021-22, thus remaining anchored

	<0	[0,2)	[2,5]	(5,10]	>10
2018M12	33	42	7	8	10
2019M12	41	29	14	13	3
2020M12	18	42	18	15	7
2021M12	8	33	31	14	15
2022M03	9	11	11	37	32
2022M06	4	11	9	24	52
2022M09	5	8	7	17	64
2022M11	5	8	5	13	69
2022M12	5	6	6	20	63
2023M03	7	10	12	13	57
2023M06	10	9	8	21	53
2023M09	12	14	13	35	26

Source: Eurostat and NBRNM staff calculations.

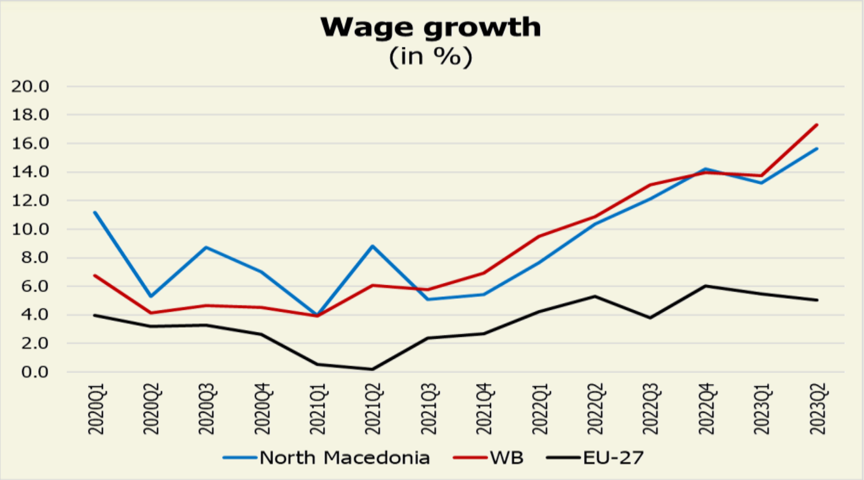
Inflation and inflation expectations



Source: European Commission.
Note: Net percentages are obtained by subtracting the percentage of respondents indicating that prices will decrease from the percentage of respondents indicating that prices will increase over the next 12 months.

However, wages are growing at a pace exceeding the productivity that may contribute to sticky core inflation

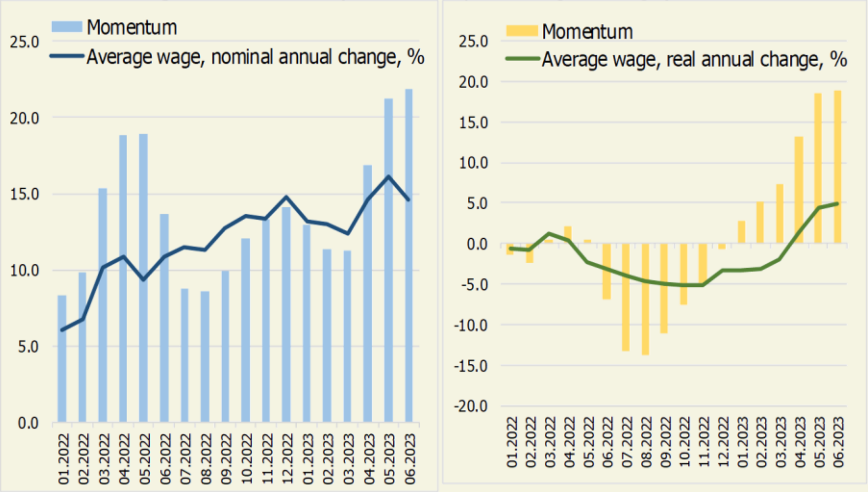
- The **pace of wage growth** is similar to the WB region, but more than double in comparison with the EU



Source: wiiw.

- while **wage momentum** remains strong

Wage momentum (annualised percentage change)

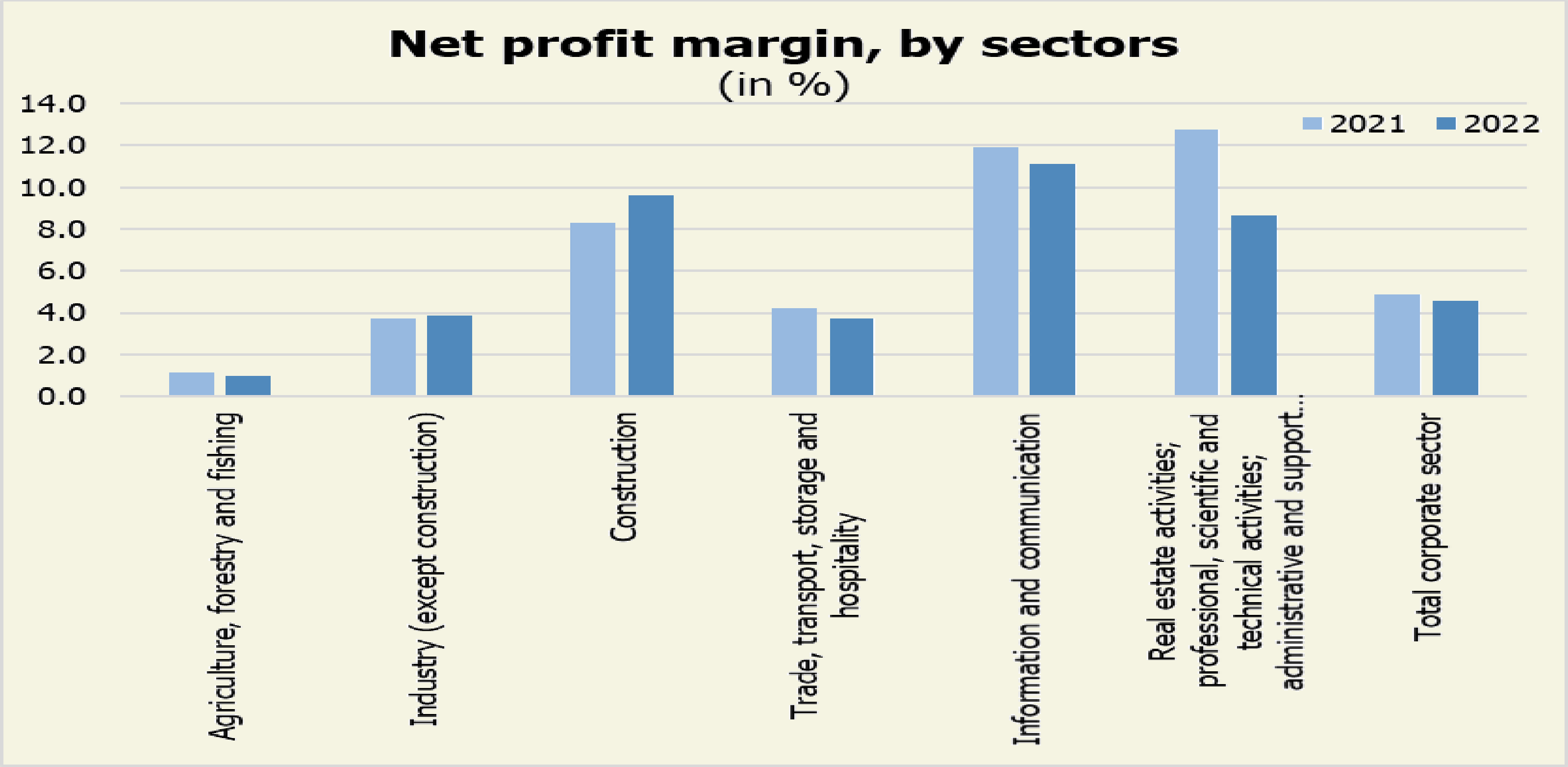


Sources: SSO and NBRNM.

Notes: Momentum is defined as annualized change 3 months on 3 months rates of the average wage, seasonally adjusted data.

And the corporate sector remained profitable despite the rise in input prices-costs have been passed on to consumers

- **Profit margins have been maintained** and in most of the sectors even increased indicating that pricing policy of companies has been and may continue to be one of the factors contributing to inflationary pressures



What are the potential side effects of tighter MP for financial stability?

- **Recent banking stress in the US and Switzerland is a powerful reminder** that monetary tightening can have significant implications on financial stability…

- …especially if it is unexpected, rapid, follows a long period of accommodative monetary policy, and if combined with weaker risk management, prudential regulation and supervisory oversight

- **The rise in interest rate** can burden banks' balance sheets, mainly via two channels - the so-called **"hidden losses",** because of the assets valuation (SVB), as well as through rising **nonperforming loans,** as the interest burden increases and disposable incomes decline

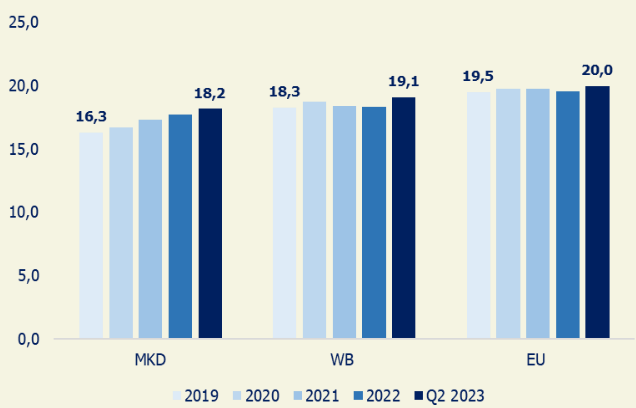
- This raises the issue of possible tradeoff between price and financial stability, or so-called **"financial dominance"** phenomenon, where financial stability concerns limit the monetary policy headroom

- **To avoid "financial dominance" two prerequisites are critical:**
  - resilient banking sector balance sheets; and
  - effective macro-prudential and resolution tools

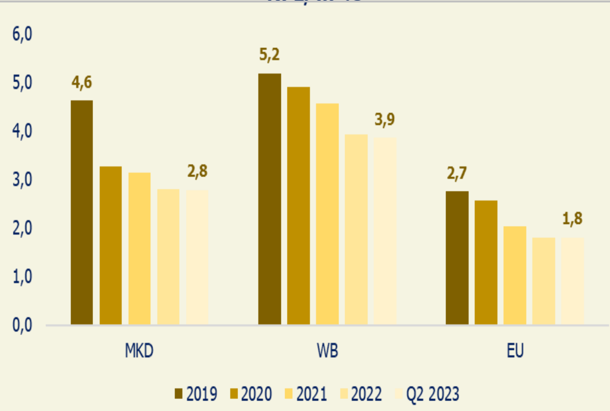
Resilience of banks' balance sheets

- **Macedonian banking system remains strong and resilient** - despite the crisis, buffers have continued to strengthen
- **Solvency and liquidity are strong –** capital adequacy ratio (18%) is highest in the last 15 years
- **The quality of the portfolio is sound** – NPL standing at their historical lows at 2.8%
- Yet, **no room for complacency** as risks can come to the fore with a time lag, conditioned on the capacity for debt servicing of corporates and households

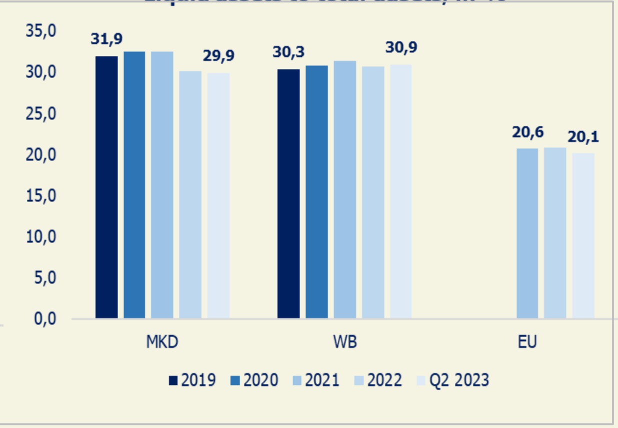
Capital adequacy ratio, in %



NPL, in %

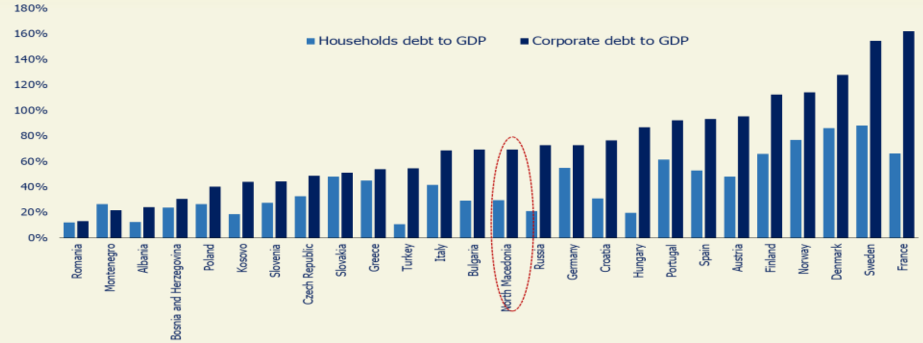


Liquid assets to total aasets, in %

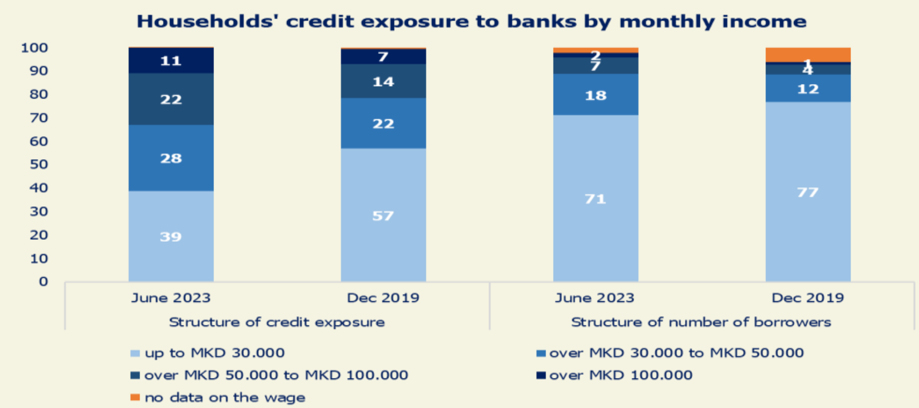


Corporate and households balance sheet – the key to stability of banking system

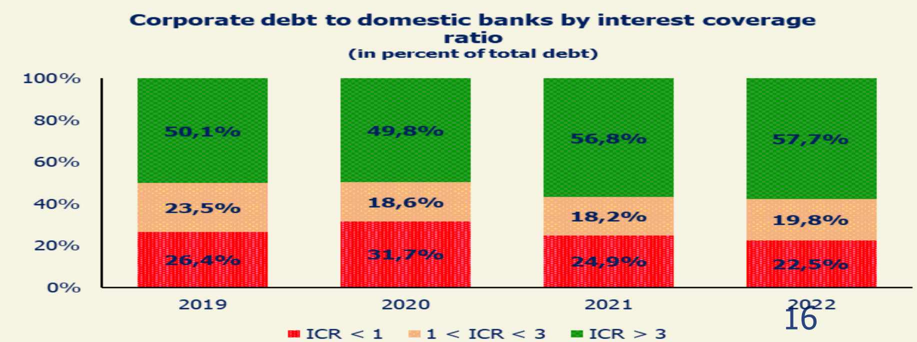
- **So far vulnerability indicators point to contained risks,** as the leverage of households and corporates remains bellow standard vulnerability thresholds, also confirmed by the low NPLs



- Yet, **more granular data reveal that debt at risk is non-negligible**, both for households and corporates:
  - **loans to households with income below the average net wage is** standing at 39%, though lower compared to the pre-pandemic period

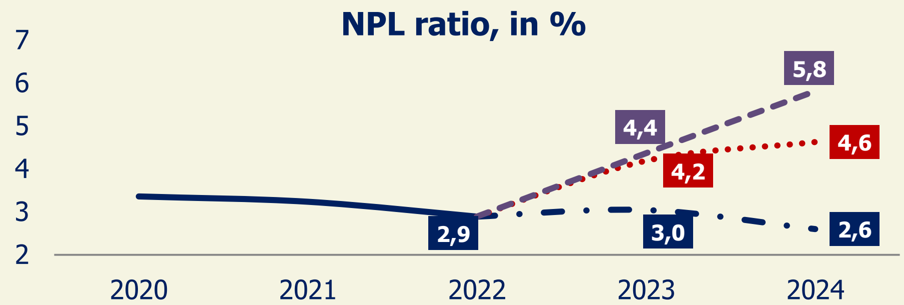


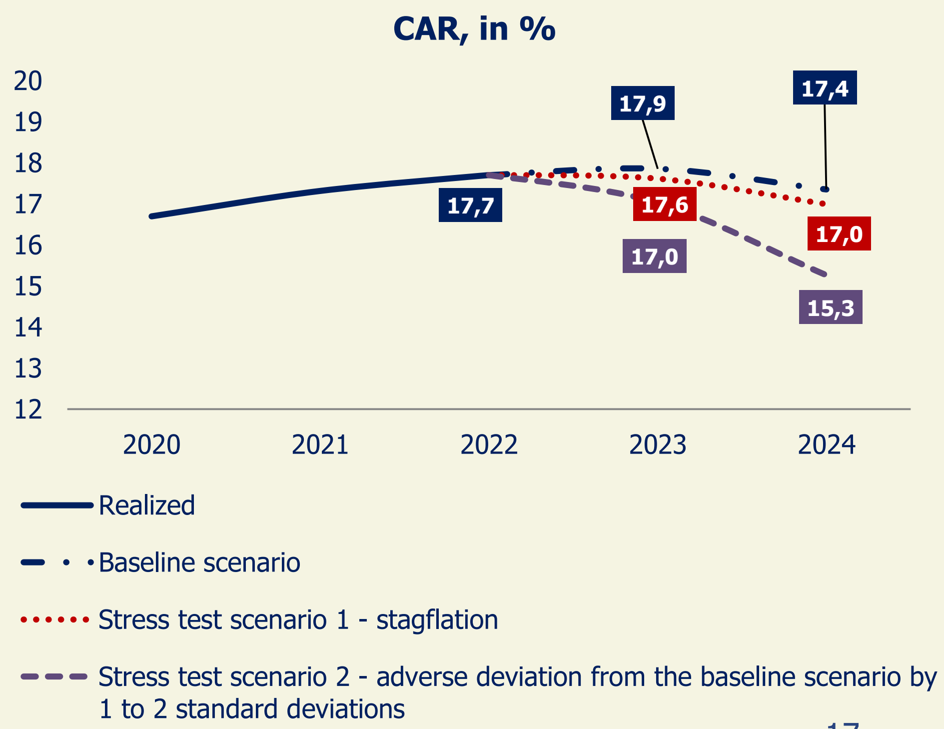
  - **Loans to companies with ICR lower than 3** account for about 42%, although lower compared to the pre-pandemic period
  - **vigilance is needed** as repayment capacity can weaken in a higher-for-longer interest rate environment



Stress tests, the tool for assessing the resilience to shocks, point to similar conclusions

- **The latest standard macro-stress test of the banking system confirms robust** solvency and portfolio quality, when imposing more severe macro shocks
- **The tailored made stress test,** imposing sharper increase of interest rates also points to resilient balance sheets
- **Still, risks are present** – warranting preventive **macro-prudential measures**
- We have introduced new capital buffers and set borrower-based measures (DSTI and LTV), to prevent excess leverage…
- ….as research indicates that these measures, ahead or during monetary tightening **reduce the likelihood of financial stress and increase the room for monetary policy**





Conclusion

- Central banks' response to swift transition from low to high inflationary environment was a **swift transition from accommodative to restrictive monetary policy**

- No doubt, this can **adversely affect** the already slow post-pandemic recovery and unearth some vulnerabilities in financial systems

- Still, **we should not forget the key lessons from the '80s** that moving too slowly and too softly can entail more costly subsequent tightening with higher costs for the output and financial stability.

- **To minimize costs of tighter MP**, well coordinated macroeconomic policy mix is the first, although not the only prerequisite as macroeconomic policies cannot be a substitute for structural policies that are key for addressing the vulnerabilities and lifting the long-term growth potential

Thank you for your attention!