Spillovers of the ECB monetary accommodation into CESEE region?

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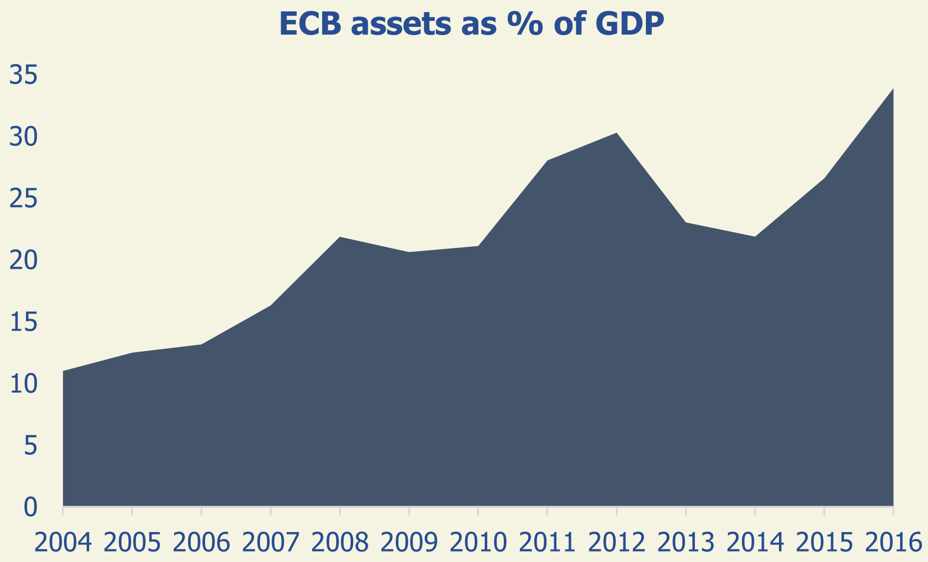
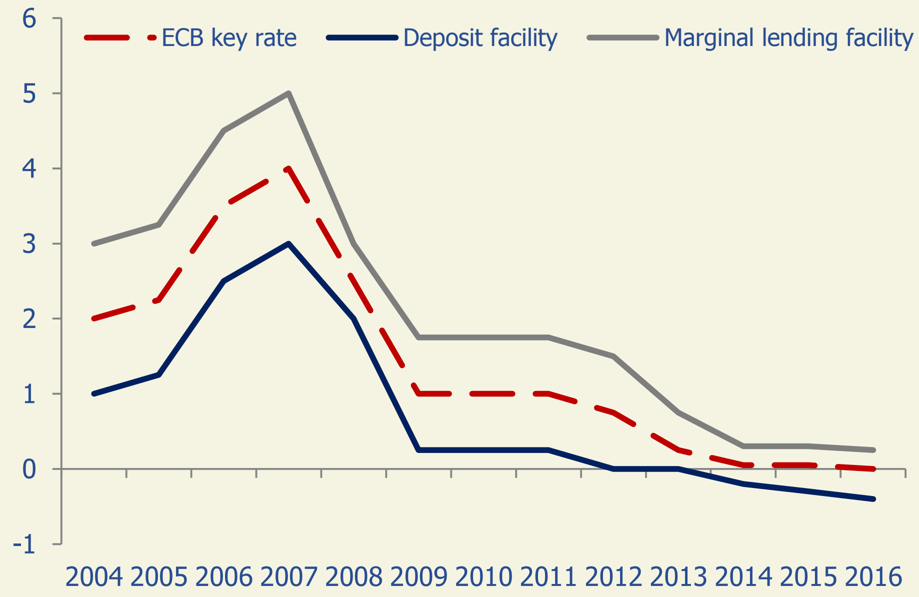
Outline

- The impact of loose ECB monetary policy on CESEE economies
- Are CESEE economies vulnerable to ECB tapering?

Unprecedented monetary accommodation since the onset of the crisis

- ECB has provided unprecedented monetary stimulus
  - Expansion of Central banks' balance sheets
  - Decline of the policy rates and unprecedented breaking of the nominal zero lower bound.





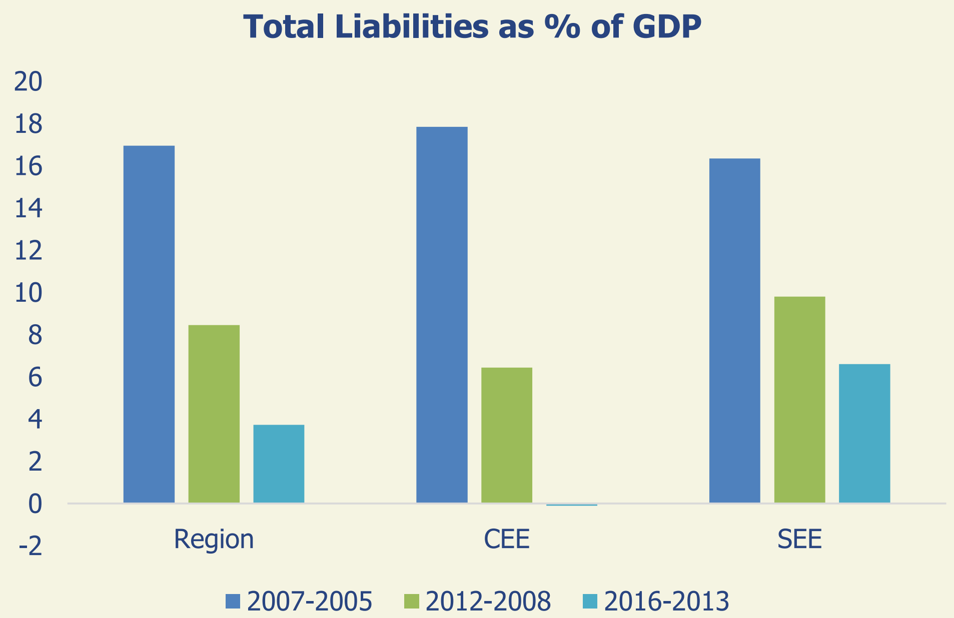
CESEE region exposed to the Euro Area

- Strong trade and financial links of the region with the Euro Area, which raises the question on whether and how the ECB monetary stimulus impacted the region.
- Several **possible transmission channels:**

- **Financial channel:**
  - **non-conventional: capital inflows** – allocation of part of the injected liquidity by the ECB, on the financial markets in the region thus increasing the cross-border capital flows, compression of the yields and positive effect on asset prices;
  - **conventional: low ECB policy rate -** provides room for downward adjustment of the policy rates and subsequently lending rates in the region (in particular for countries with some type of fixed exchange rate);
- **Trade channel -** recovery of foreign demand provides positive impulse for export sector, which in turn positively affects investments and consumption;
- **Exchange rate channel** – impact on trade and import prices;
- **Confidence/expectations channel** - prospects for stronger recovery of the main trading partner positively affect expectations of domestic agents.

Has loose ECB policy been conducive to capital inflows in the region?

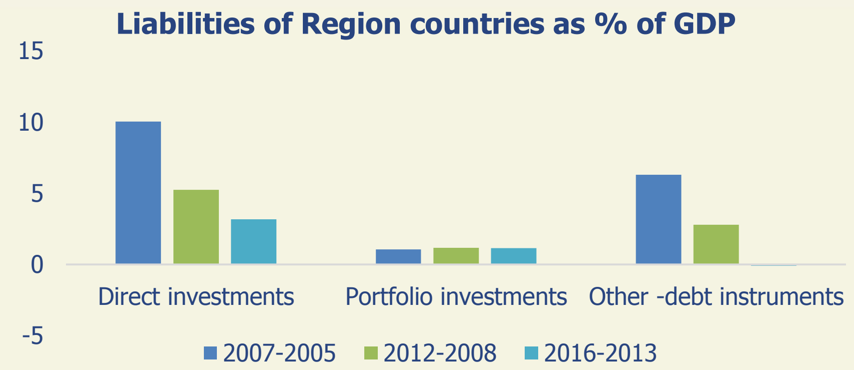
- Capital inflows continued, albeit at a decelerated pace across the region;
- Slowdown visible in the last couple of years, in particular;
- Stronger adjustment in CEE countries, compared to the SEE region (partly reflecting different initial conditions).

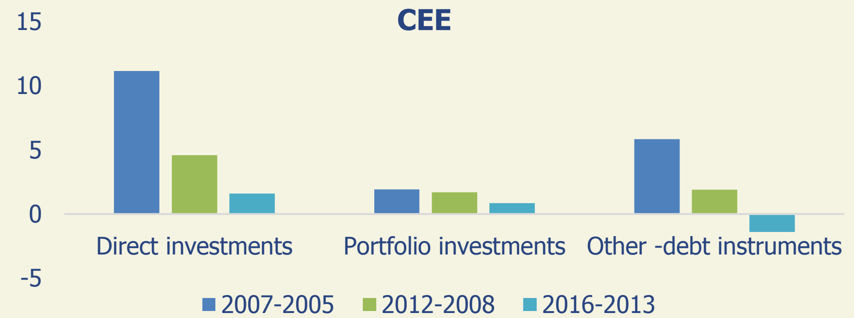


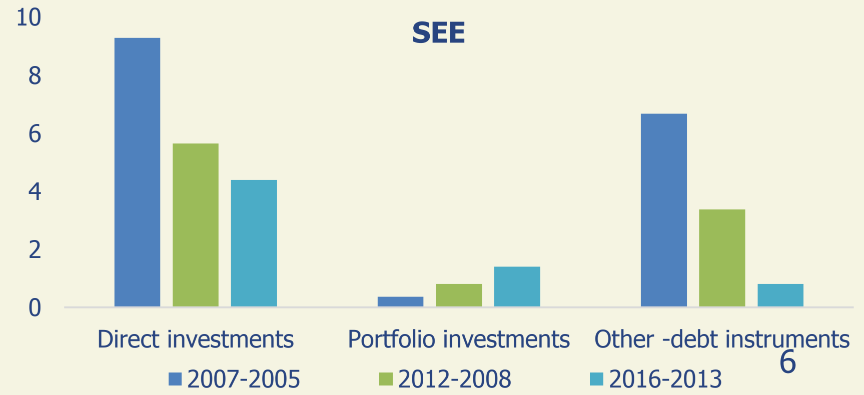
In the presentation CEE countries group is comprised of Poland, Czech Republic, Romania and Hungary, while SEE countries group is comprised of Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Serbia and Macedonia. Region is average of all the countries.

Has loose ECB policy been conducive to capital inflows in the region?

- Deceleration across almost all types of capital inflows
  - deceleration for "other financial flows", in particular;
- Exception are portfolio flows that has remained broadly stable;
- Overall: seems ECB accommodative police has supported capital inflows in the region (mostly through portfolio and FDI inflows).

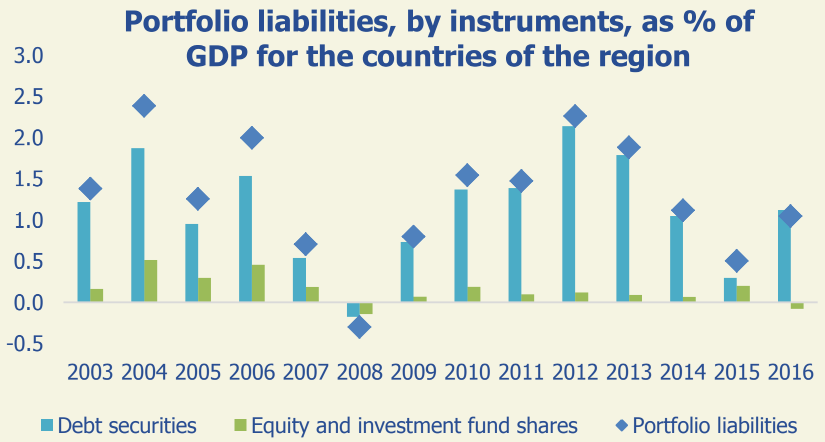


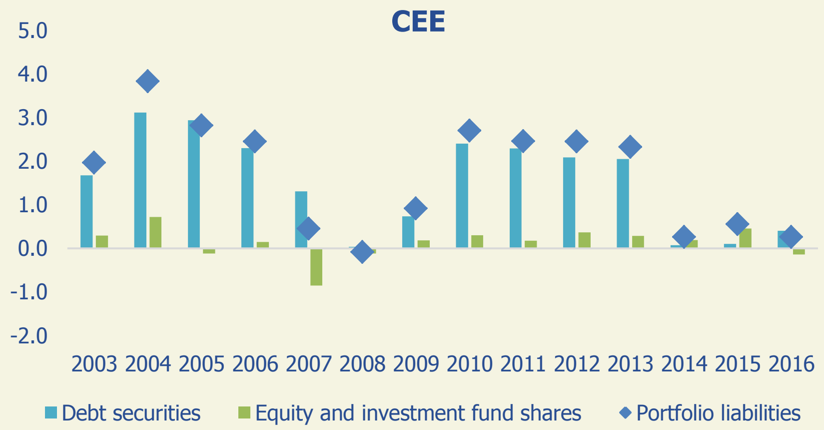


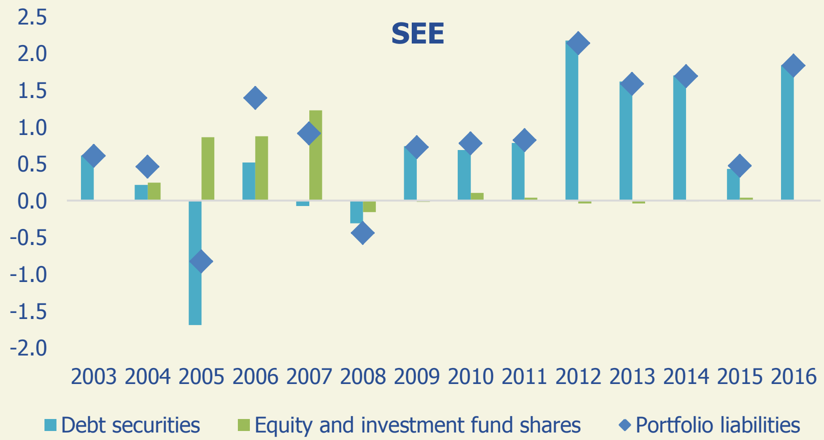


Has loose ECB policy been conducive to capital inflows in the region?

- Portfolio flows, almost exclusively driven by debt instruments…

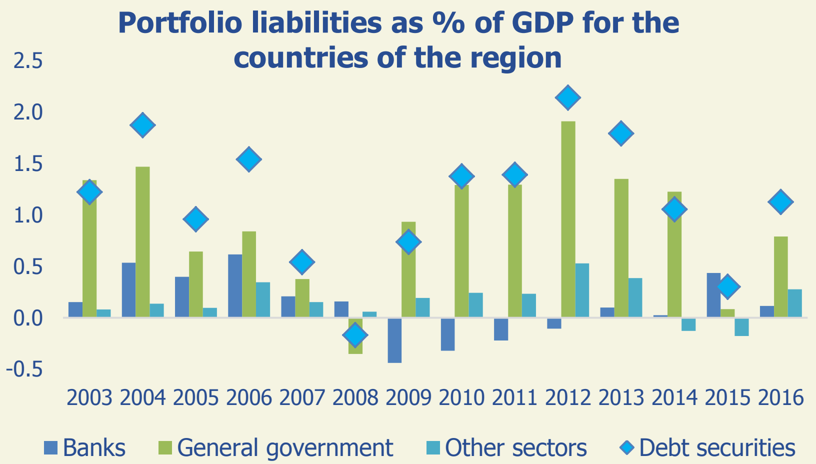


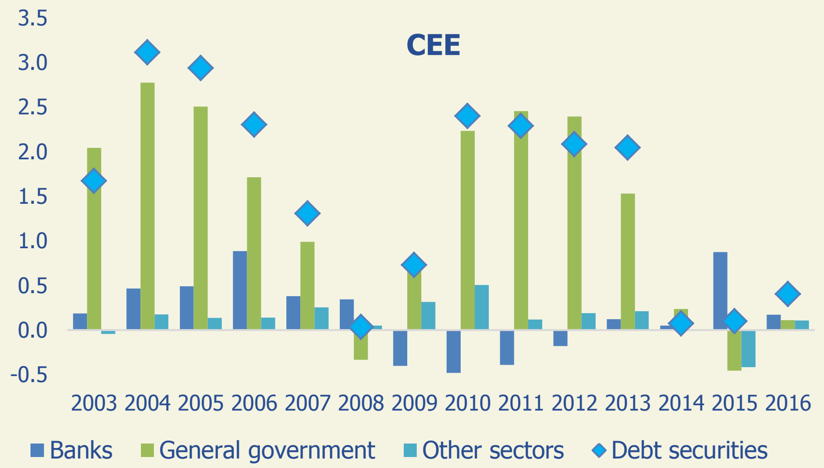


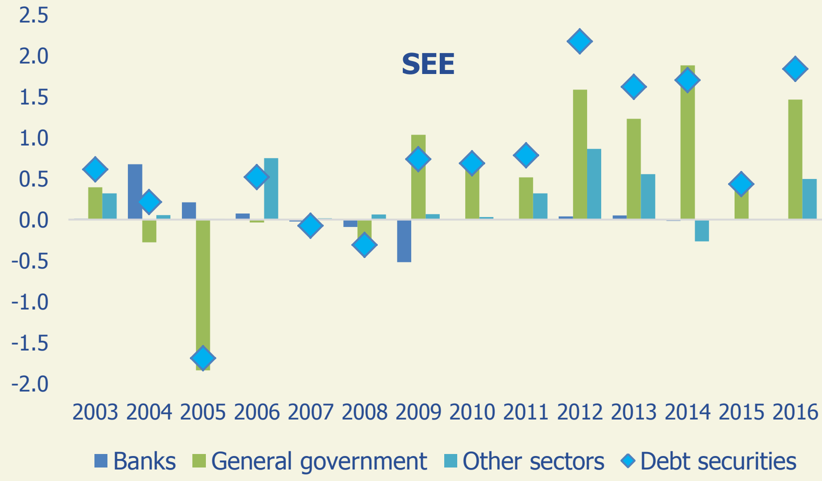


Has loose ECB policy been conducive to capital inflows in the region?

…mainly explained by government borrowing

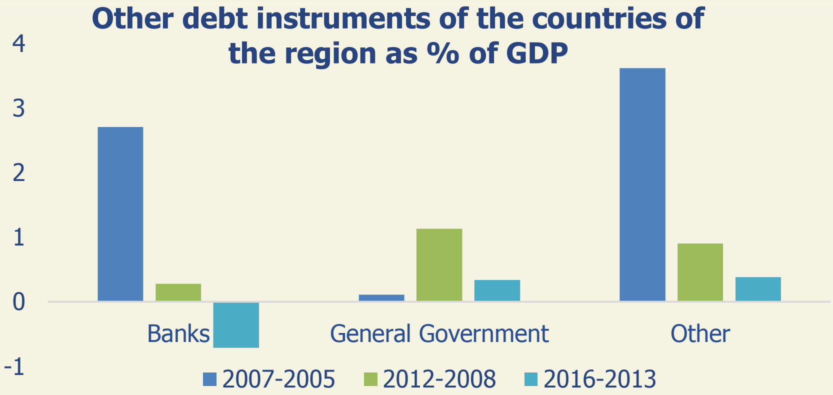


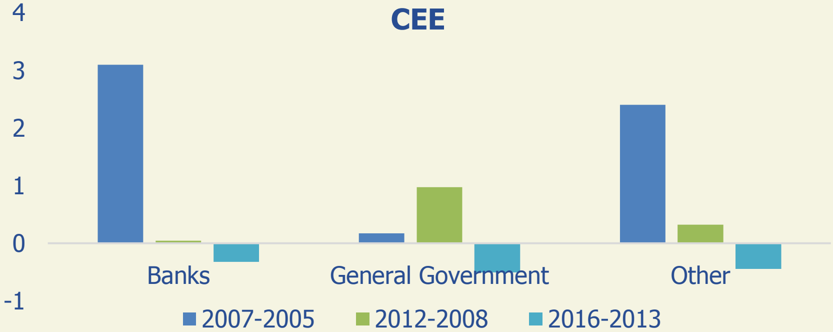


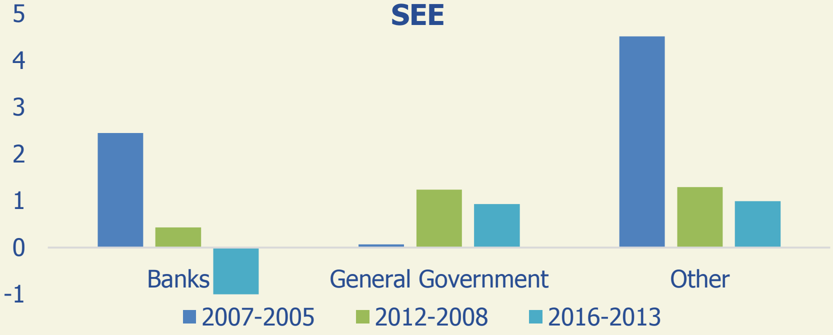


Has loose ECB policy been conducive to capital inflows in the region?

- The adjustment in "other financial flows", reflection of the deleveraging of foreign parent banks in the region…
- …holds for CEE countries as well as for the SEE region…
- …no spillover effect through bank liquidity channel

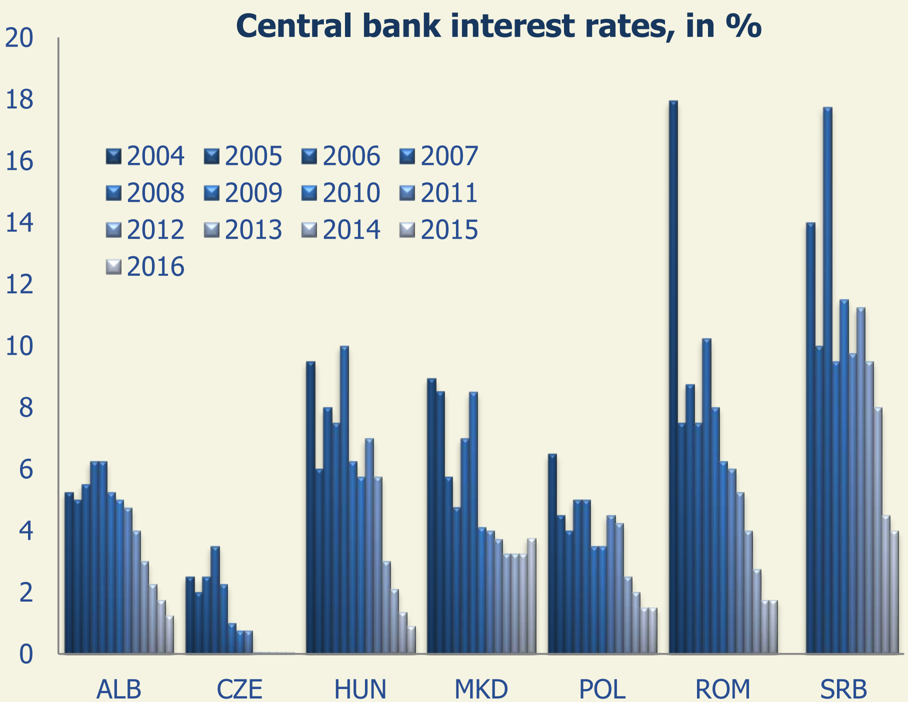


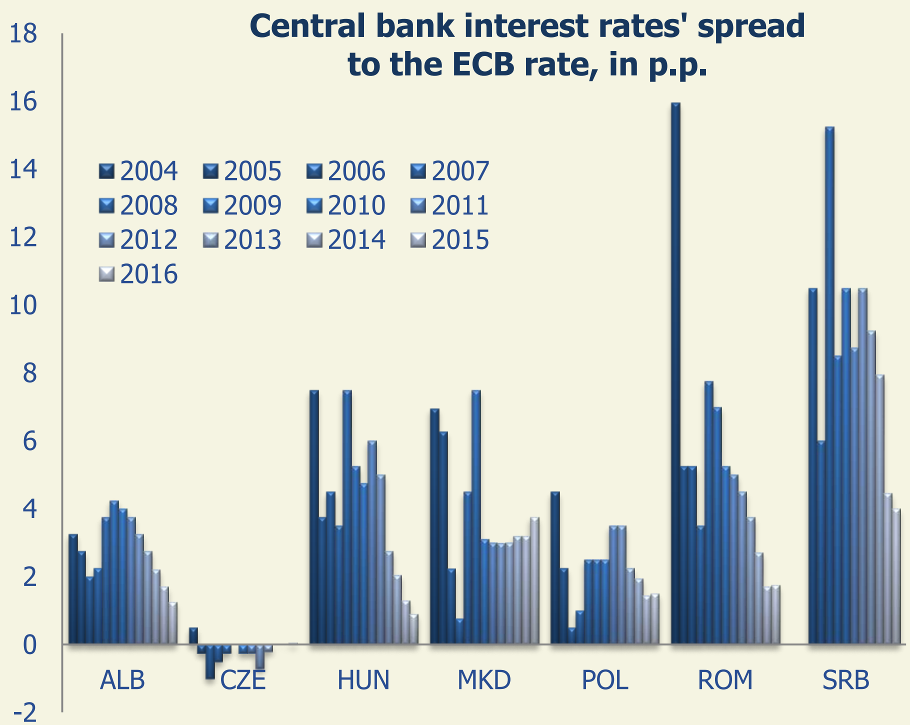




How have capital inflows affected financial conditions?

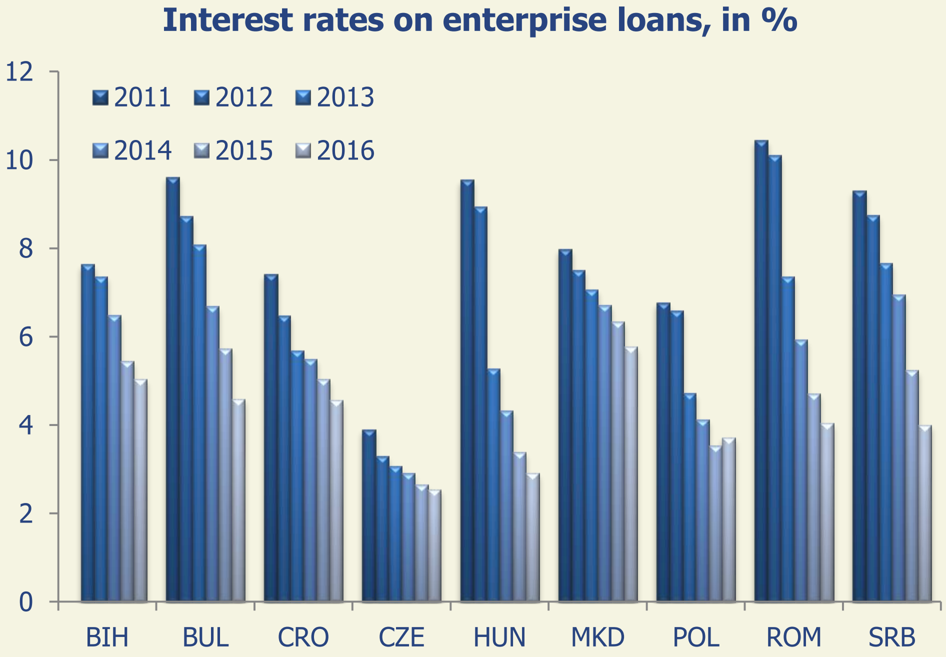
- Non-conventional measures (increased liquidity) and conventional measures (low/negative interest rate and narrowing CB interest rates' spread to the ECB rate) allowed a room for prolonged accommodative monetary stance in the region;
- Accommodation present across the board, notwithstanding the exchange rate regime





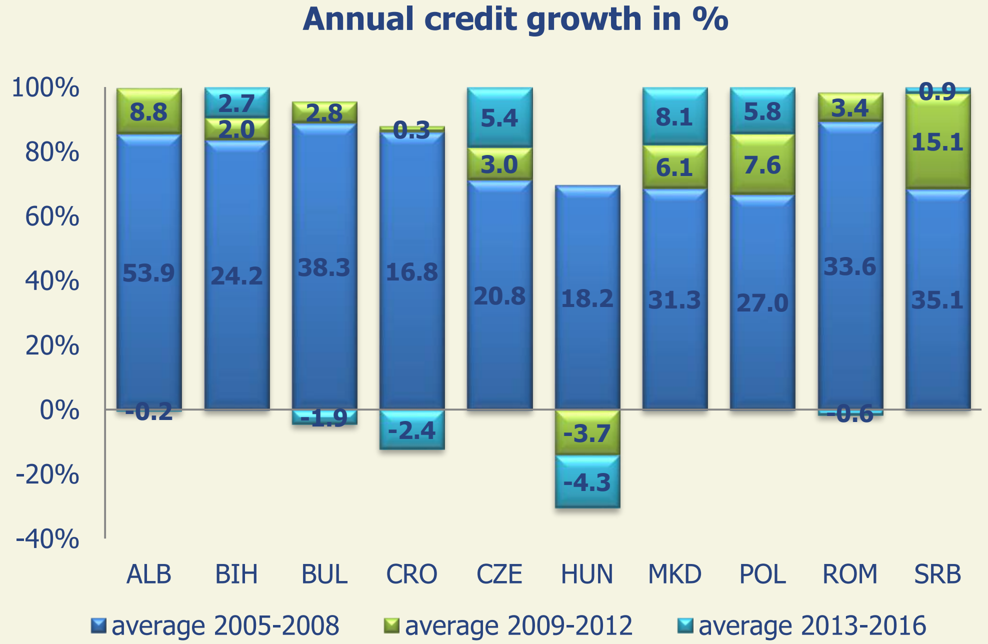
How have capital inflows affected financial conditions?

- Loose monetary stance was conducive to downward adjustment of lending rates



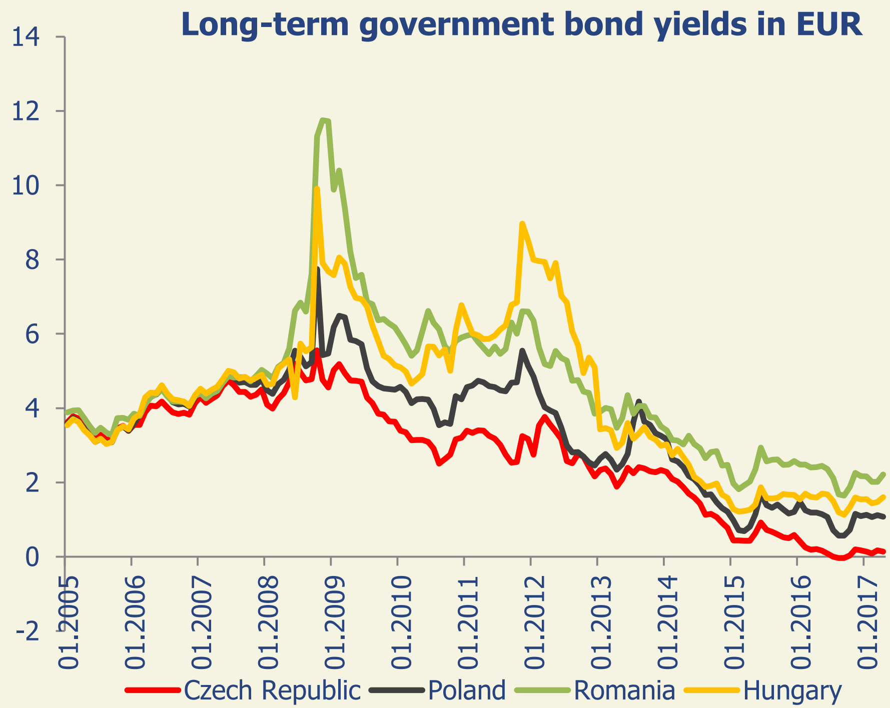
How have capital inflows affected financial conditions?

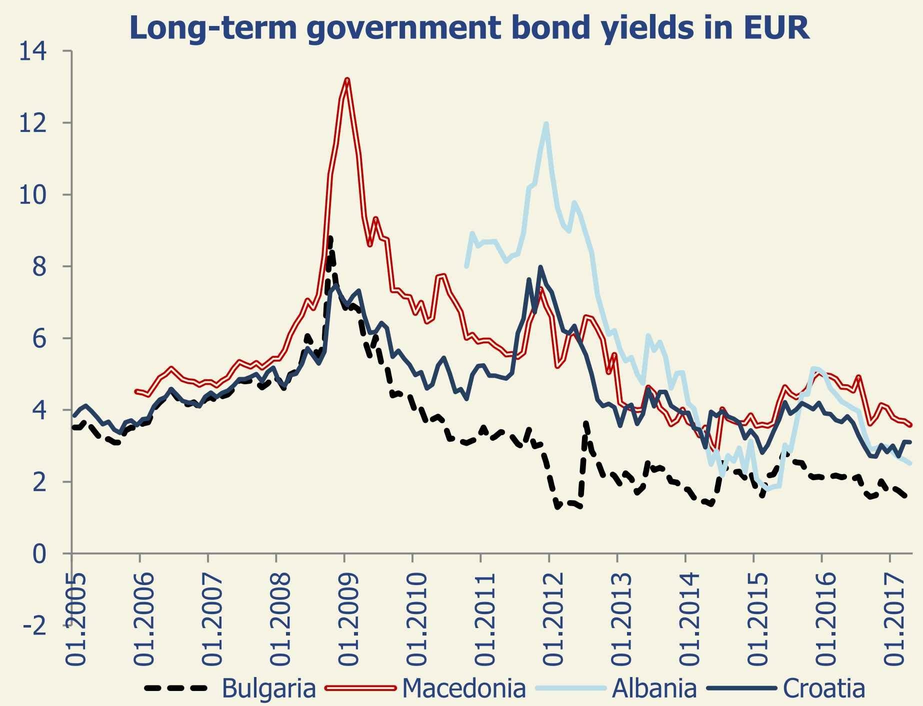
- Reduced cost of financing supported the credit demand, although credit growth in most of the countries remained anemic;
- More fundamental constraints in play – new regulatory environment and capital requirements, and NPL's as well;
- Recovery of credit activity in the last several years, reflecting demand and supply factors



Implications for the government sector

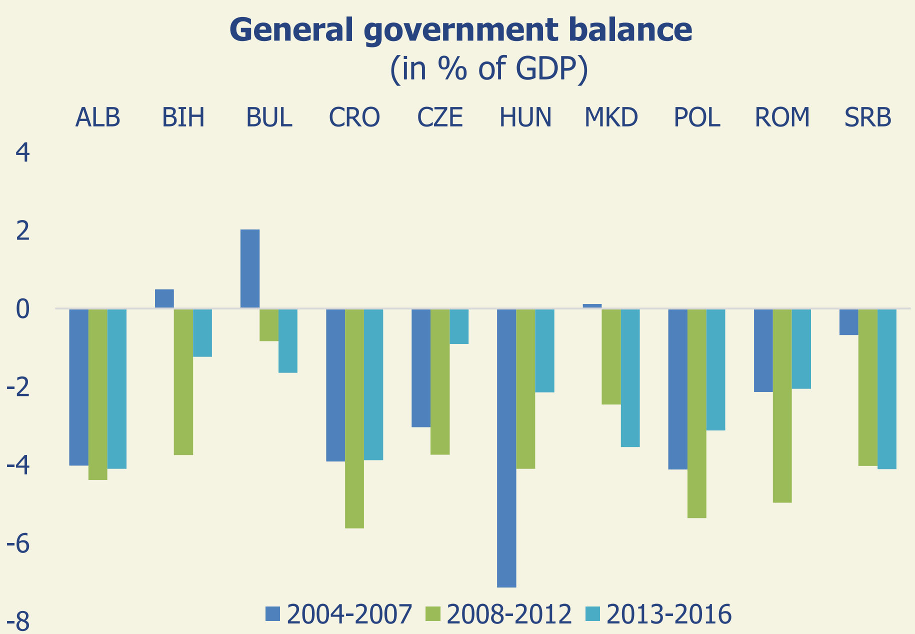
- Government sector across all countries benefited from low interest rate environment and increased liquidity at European markets



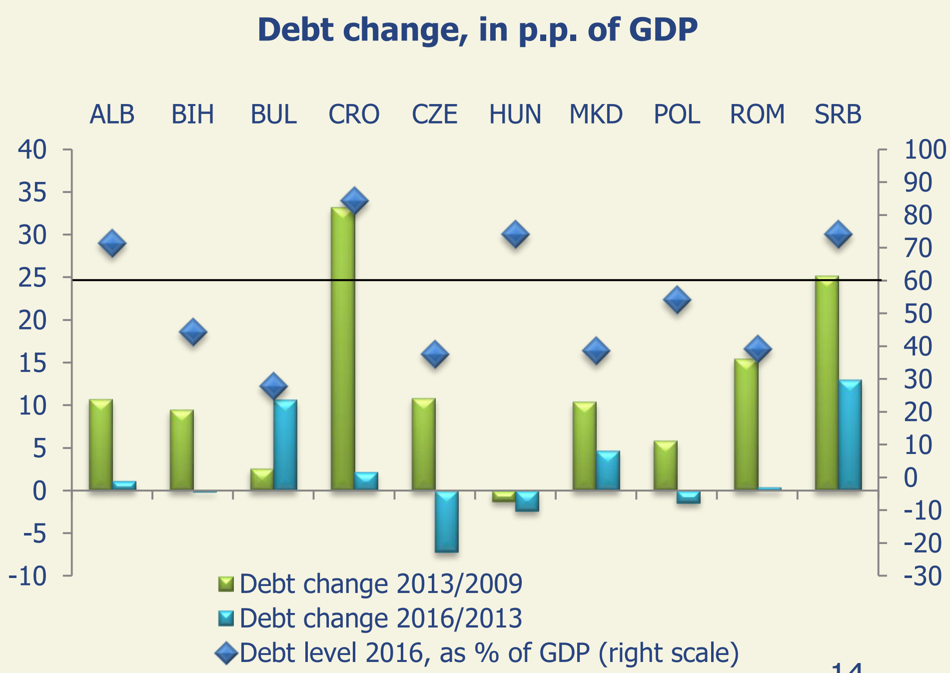


Implications for the government sector

- Low interest rate environment conducive for government borrowing
- Public debt in the region went on a rising track, after the burst of the crisis, although growing at a slower pace, or even declining in some cases, in the most recent period
- Despite this, public debt level remained elevated

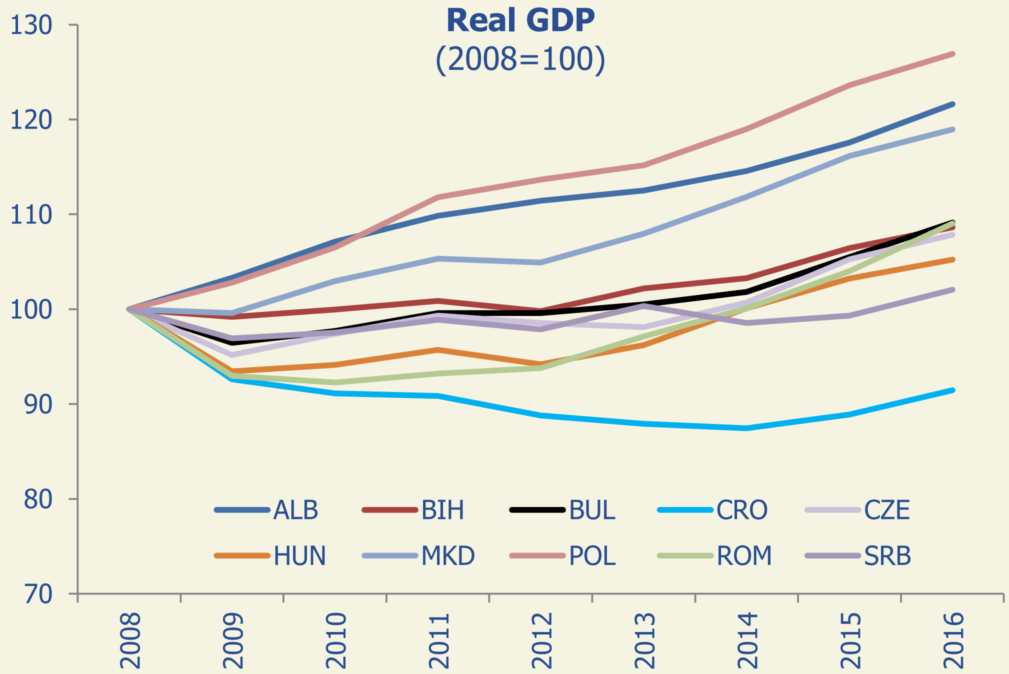


Source: IMF.



Impact on economic recovery

- Economic recovery observed in all of the countries, amid favorable financial conditions, recovery of external demand and country-specific structural factors
- Almost all countries (except for Croatia) have exceeded the pre-crisis level of GDP, with Poland, Albania and Macedonia outperforming the average

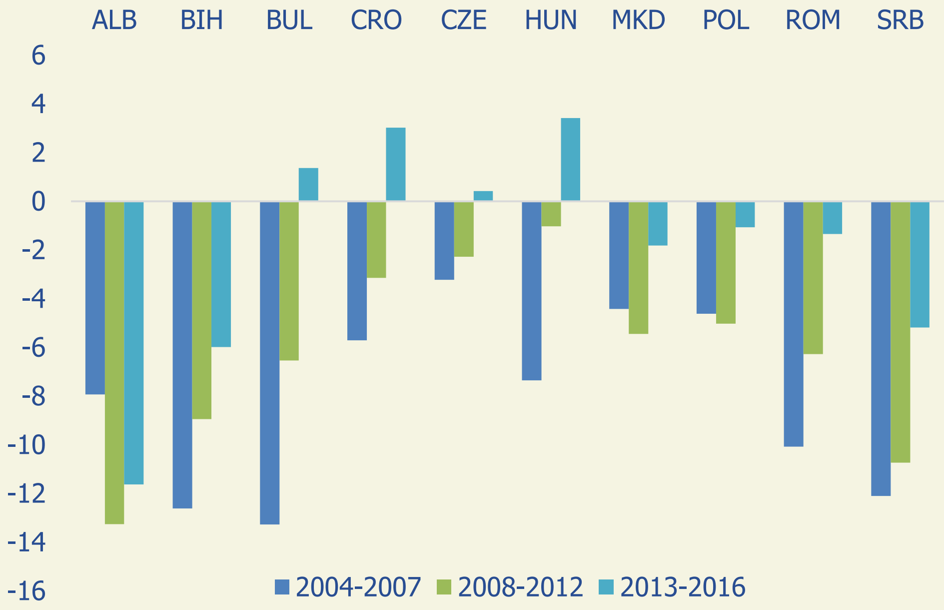


Source: Eurostat and IMF.

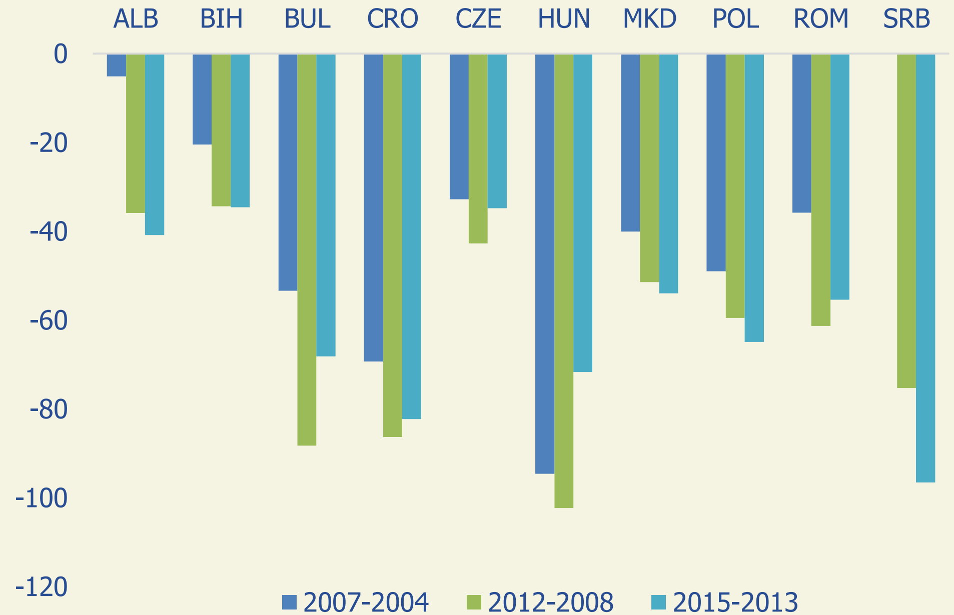
Any imbalances in place? – further considerations

- Seems that there are no clear signs of large **external imbalances**
- CAD remains low in most of the countries
- Still, in some countries the IIP (proxy of external exposure) exceeds the EC threshold of -35% of GDP, underlying the need for vigilance

Current account balance
(in % of GDP)



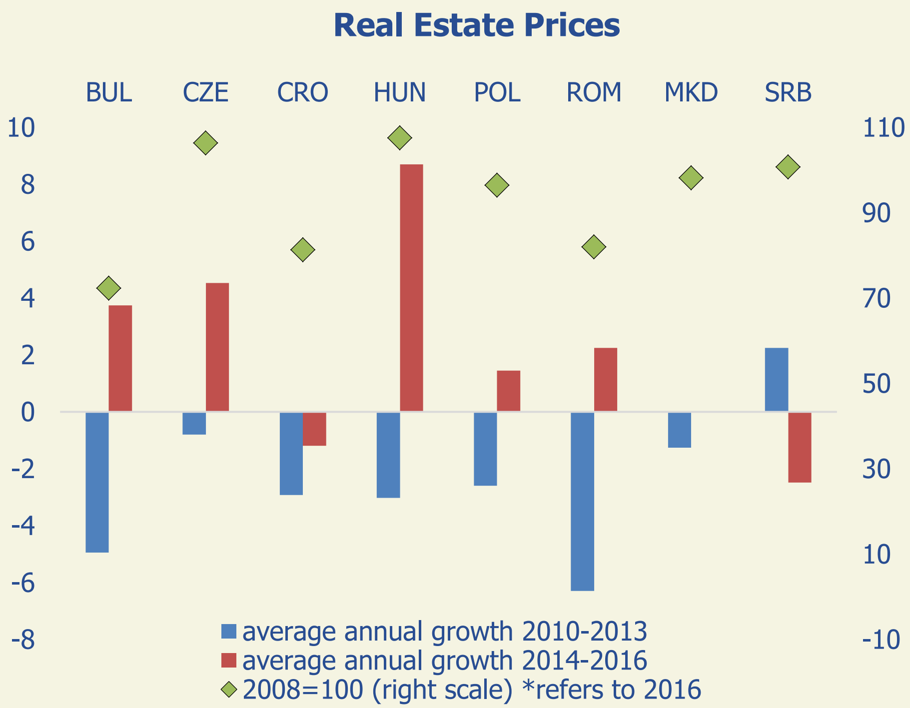
IIP, net as % of GDP

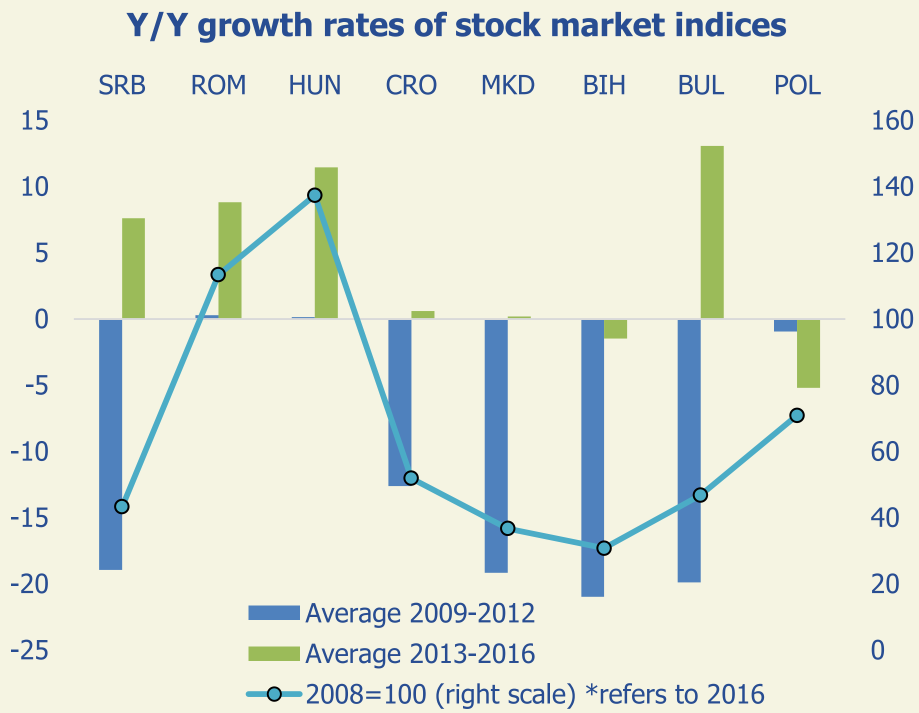


Source: IMF.

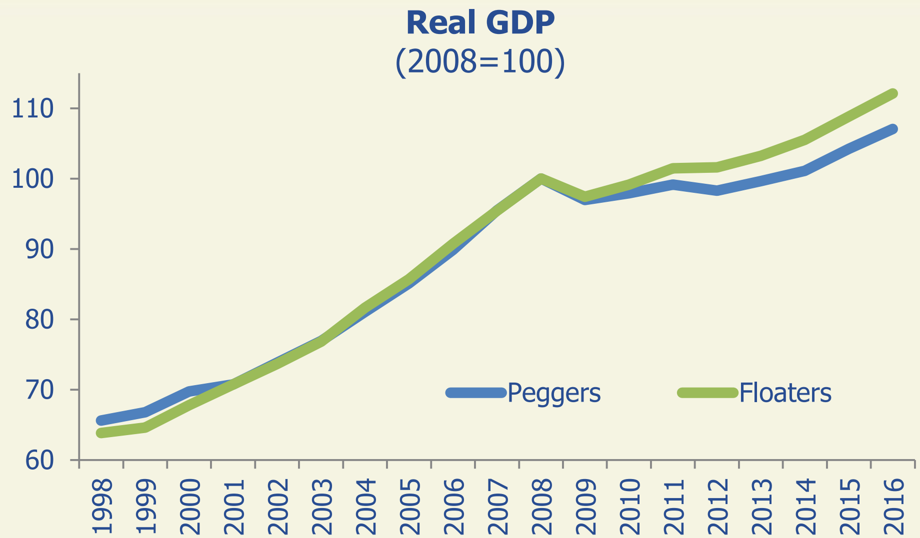
Any imbalances in place? – further considerations

- Real estate prices and stock indexes continue to recover, but remain at below the pre-crisis level

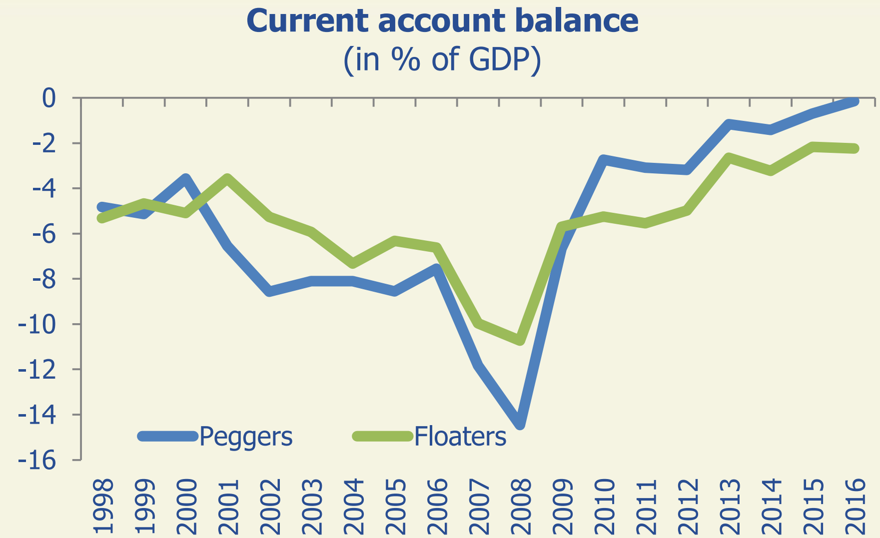




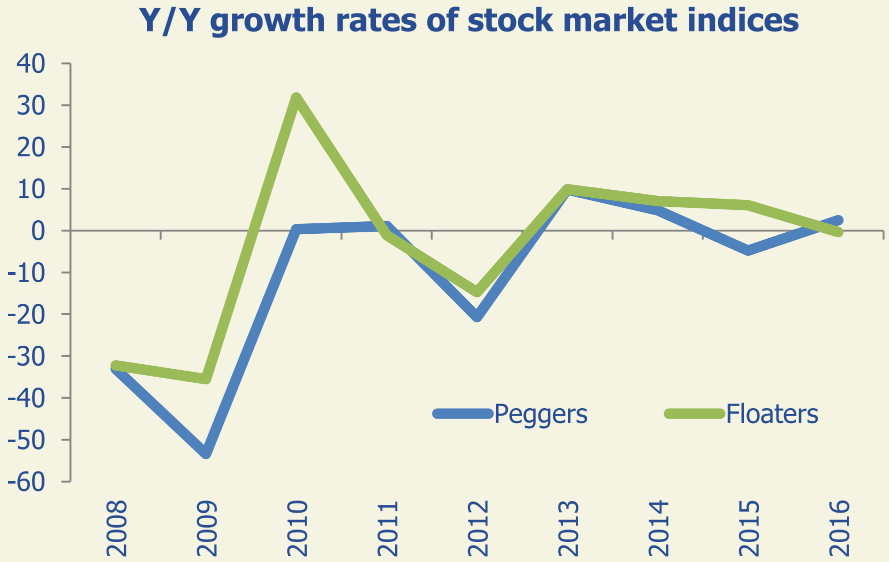
Are there any differences relative to the exchange rate regime?

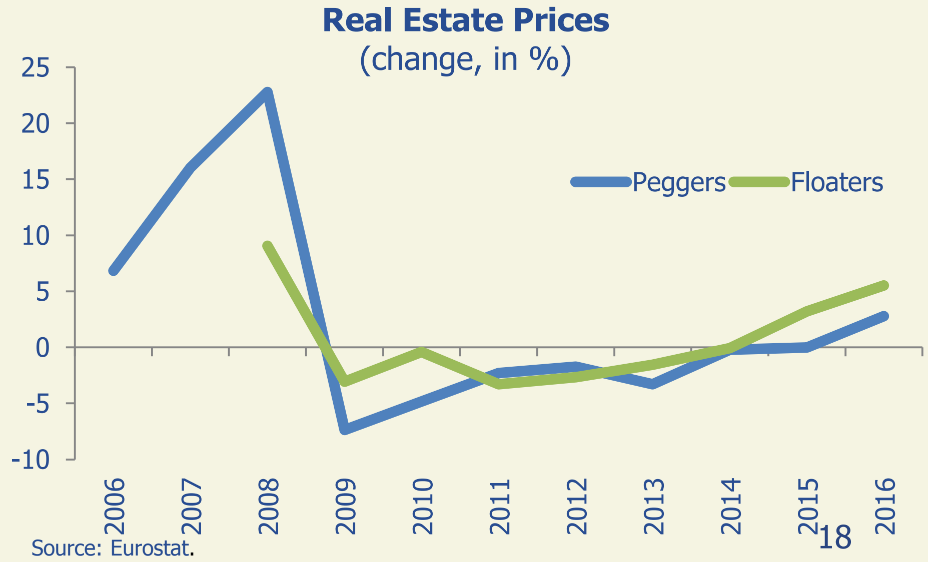


Source: Eurostat and IMF.



Source: IMF.





Source: Eurostat.

Have loose financial conditions and economic recovery created any large imbalances?

- Some vulnerabilities do exist, though overall at the moment the region seems to be in the "safe zone"

	Current Account Balance (Percent of GDP)	External Debt Amortization in 2017 (Percent of GDP)[3/]	ARA Reserve Adequacy Metric[4/]	Net External Position vis-à-vis BIS Reporting Banks (Percent of GDP)	Share of Non-Resident Holdings in Outstanding Debt Securities (Percent)	Loan to Deposit Ratio	General Government Fiscal Balance (Percent of GDP)	General Government Gross Debt (Percent of GDP)
CEE								
Czech Republic	1.1	30.0		-15.6	35.8	78.9	0.2	37.7
Hungary	4.3	12.0	128.6	-9.5	49.1	85.2	-1.8	74.2
Poland	-0.3	20.7	126.0	-13.8	39.7	106.3	-2.9	53.5
SEE EU								
Bulgaria	4.2	14.9	165.4	7.0	17.7	81.5	1.6	27.8
Croatia	3.9	28.5	97.9	-20.5	29.5	118.6	-1.5	84.4
Romania	-2.4	22.6	162.2	-11.7	34.5	96.4	-2.4	39.2
SEE non-EU								
Albania	-12.1	5.6	166.3	5.2	44.4	55.4	-1.7	71.5
Bosnia and Herzegovina	-5.6	21.4	130.7	-3.1		109.7	0.0	44.4
Macedonia	-3.1	16.3	117.7	-4.3		92.9	-2.6	38.7
Serbia	-4.0	11.3	160.5	-5.4		104.9	-1.3	74.1
High relative exposure value	-3.8	19.2	100.0	-14.0	45.3	100.0	-3.0	60.0
Low relative exposure value	0.2	5.1	150.0	-2.3	21.1	85.0	-1.6	37.0

Source: IMF Regional Economic Issues for Central, Eastern, and Southeastern Europe "A Broadening Recovery", May 2017

Challenges ahead?!

- **Risk for the region of unexpected rapid tightening of the global financial conditions?**

- Normalization of the monetary policy of ECB

  - Closure of APP envisaged at the end of the first half of 2018, followed by changes in the interest rate

  - The “real normalization cycle” of ECB not expected before early 2019

- **A new environment of tighter global financial conditions and less available capital flows for the region might be the “new normal” in the forthcoming period.**

Challenges ahead?!

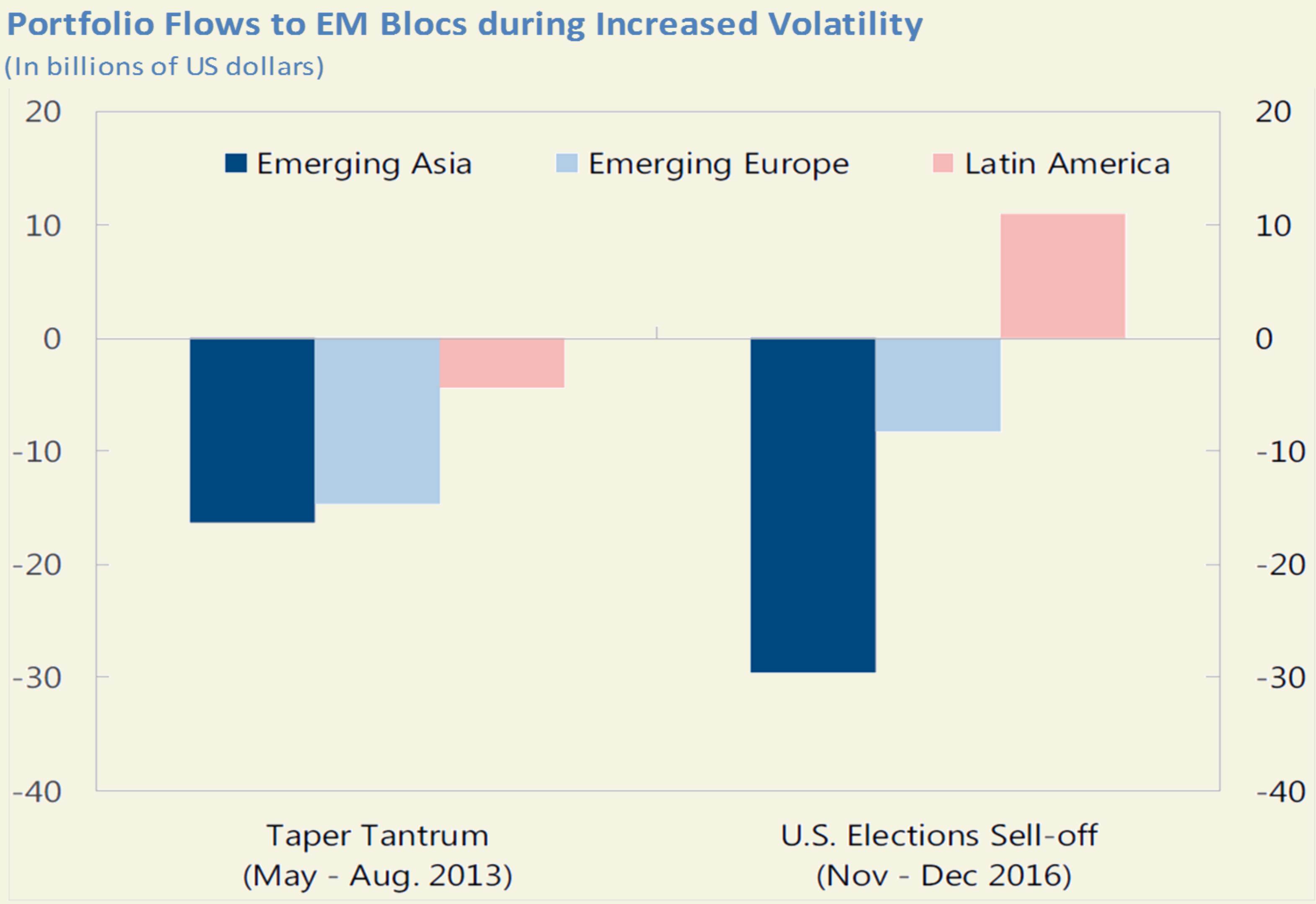
- **What have we seen in the past episodes of unanticipated tightening?**

- Lectures from the past episodes of faster than anticipated tightening
  - illustrated in the IMF Regional Economic Issues for Central, Eastern, and Southeastern Europe "A Broadening Recovery", May 2017

- Taper tantrum episode in 2013 and USA Election sell-off are recent examples

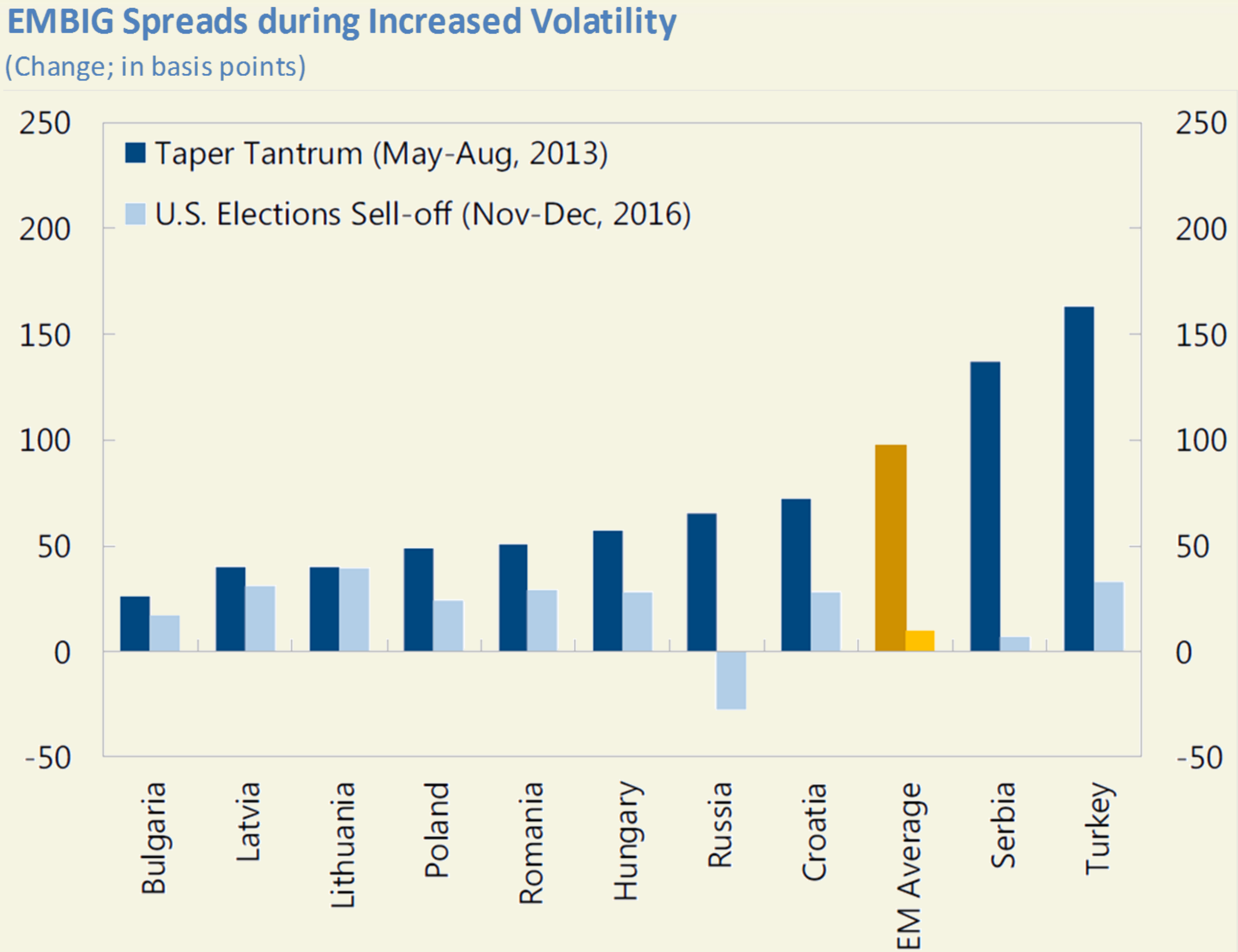
- **Some capital outflows (portfolio type) observed in Emerging Markets, widening of credit spreads and depreciation of exchange rates**

Portfolio Outflows



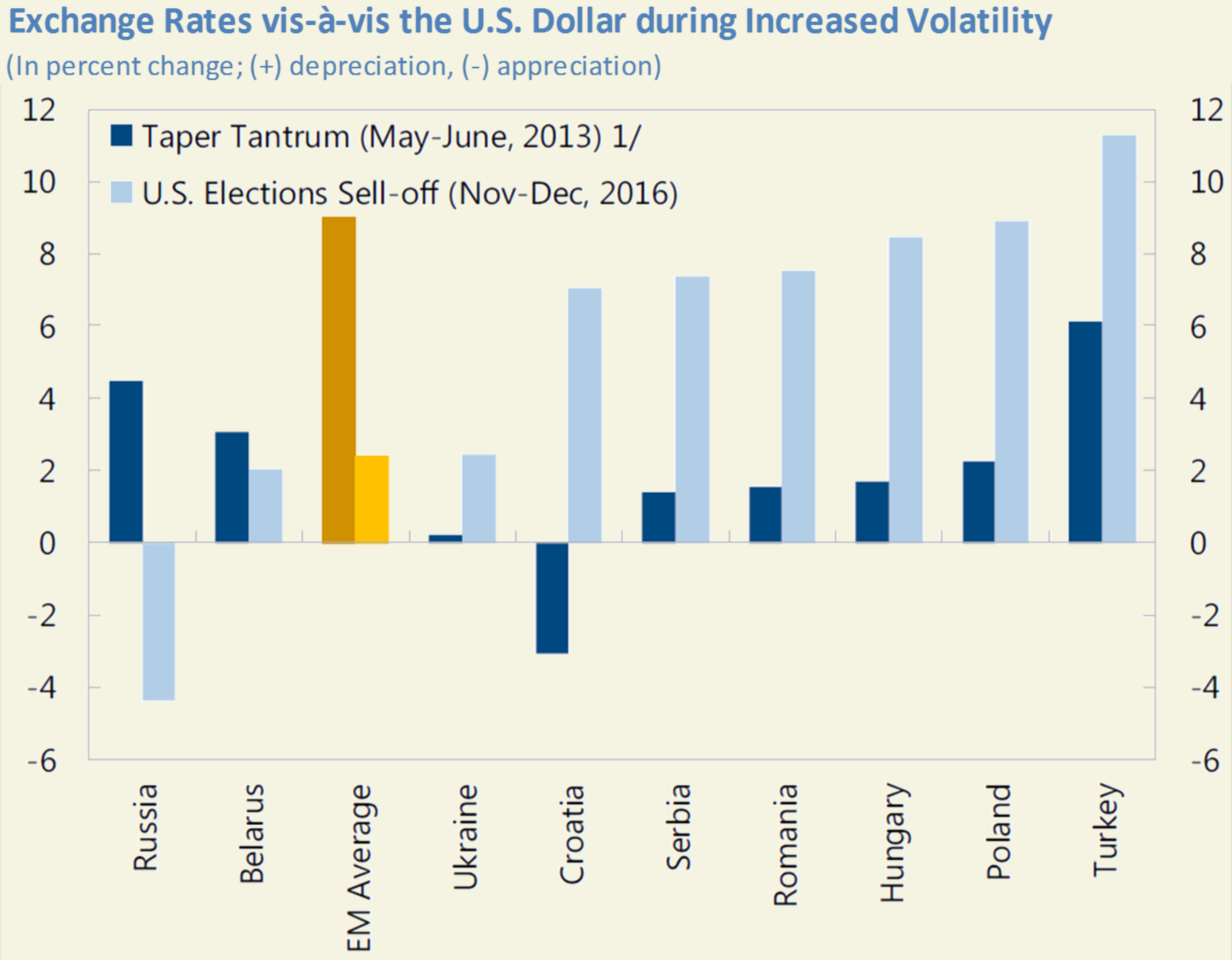
Sources: Bloomberg; IIF EM Portfolio Flow Tracker; and IMF staff calculations.

Decompression of Spreads



Sources: Bloomberg; and IMF staff calculations.

Depreciation of Currencies

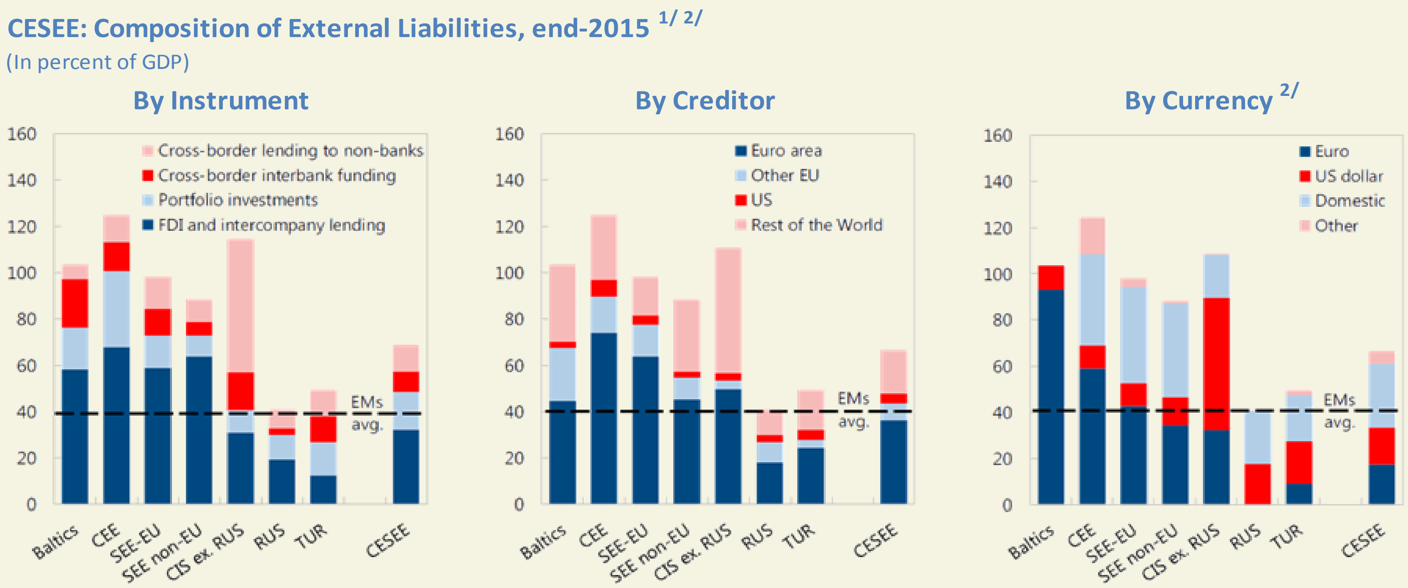


Sources: Bloomberg; and IMF staff calculations.

1/ Reflects maximum depreciation from May 22nd to June 30th, 2013.

How vulnerable is our region to forthcoming monetary tightening?!

- Vulnerability differs - reflecting the different structure of the external liabilities
- **Strength of the region:**
  - **Domination of direct investments** (which are sticky and business decision take some time to change)



Sources: BIS Locational Banking Statistics; IMF, Coordinated Direct Investment Survey; IMF, Coordinated Portfolio Investment Survey; IMF, World Economic Outlook database; IMF, International Investment Positions Statistics; Bénétrix, Lane, and Shambaugh (2015); and IMF staff calculations.
1/ Currency composition of external funding is based on weights of foreign currency liabilities estimated by Bénétrix, Lane, and Shambaugh (2015).
2/ EM average includes Argentina, Bolivia, Brazil, China, Egypt, India, Indonesia, Jordan, Kazakhstan, Malaysia, Mexico, Morocco, Nigeria, Pakistan, Paraguay, Peru, Philippines, South Africa, Thailand, Tunisia, Uruguay, and Venezuela.

How vulnerable is our region to forthcoming monetary tightening?!

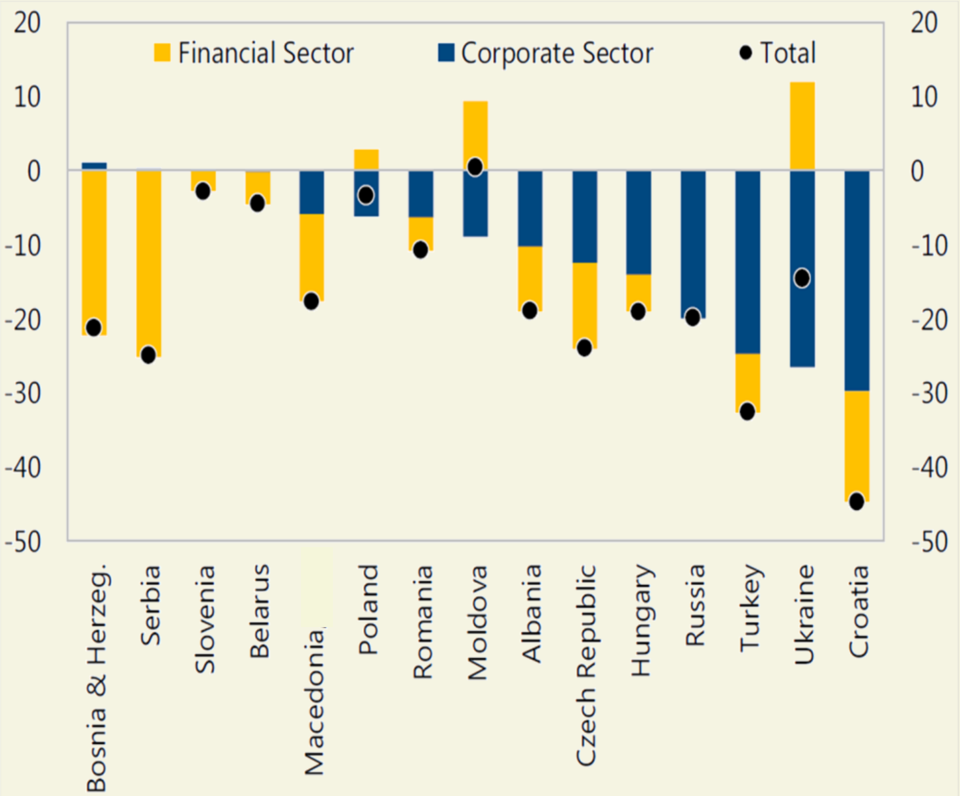
- **Weaknesses of the region and susceptibility to ECB tightening:**

  - Tightening of the financial conditions and lesser liquidity with particular **impact on the government finances**

  - In countries with **floating exchange rates, balance sheet currency mismatches** might be a potential treat

Sectoral Net FX Balance Sheet Exposures, November 2016 1/

(In percent of GDP)



Sources: BIS Locational Bank Statistics; IMF Monetary and Financial Statistics; IMF World Economic Outlook; and IMF staff calculations.
1/ Calculated as foreign currency assets less foreign currency liabilities of each sector based on reporting by domestic depository institutions, BIS banks and data on outstanding foreign currency debt instruments.

Summary

- Overall, ultra loose ECB monetary policy seems to have positively affected financial conditions in the region:
  - allowed low policy and lending rates;
  - reduced borrowing costs of sovereigns.
- Improved financial conditions coupled with recovery of growth of EU (main trading partner) provided stimulus for further recovery of economies
- Normalization of ECB policy asks for close vigilance, as some economies with weak fundamentals and low policy buffers might be adversely affected
- Going forward: investors expected to focus on strong fundamentals and differentiate their investments accordingly
- Although no major imbalance seem to be in place in CESEE region, yet the external and fiscal position in some countries requires further space built-up, thus ensuring even greater resilience to the forthcoming challenges