“A Central Bank’s Dilemmas During Highly Uncertain Times”

Talking Points of Daniel Dăianu, Member of the Board of the National Bank of Romania -- Conference of the OeNB, Vienna, 24 November 2014

The views expressed in this presentations should not be construed as being necessarily the official position of the NBR

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- Preliminary remarks
- Where does the Romanian economy come from?
- Dilemmas of older vintage
- A new age, new dilemmas

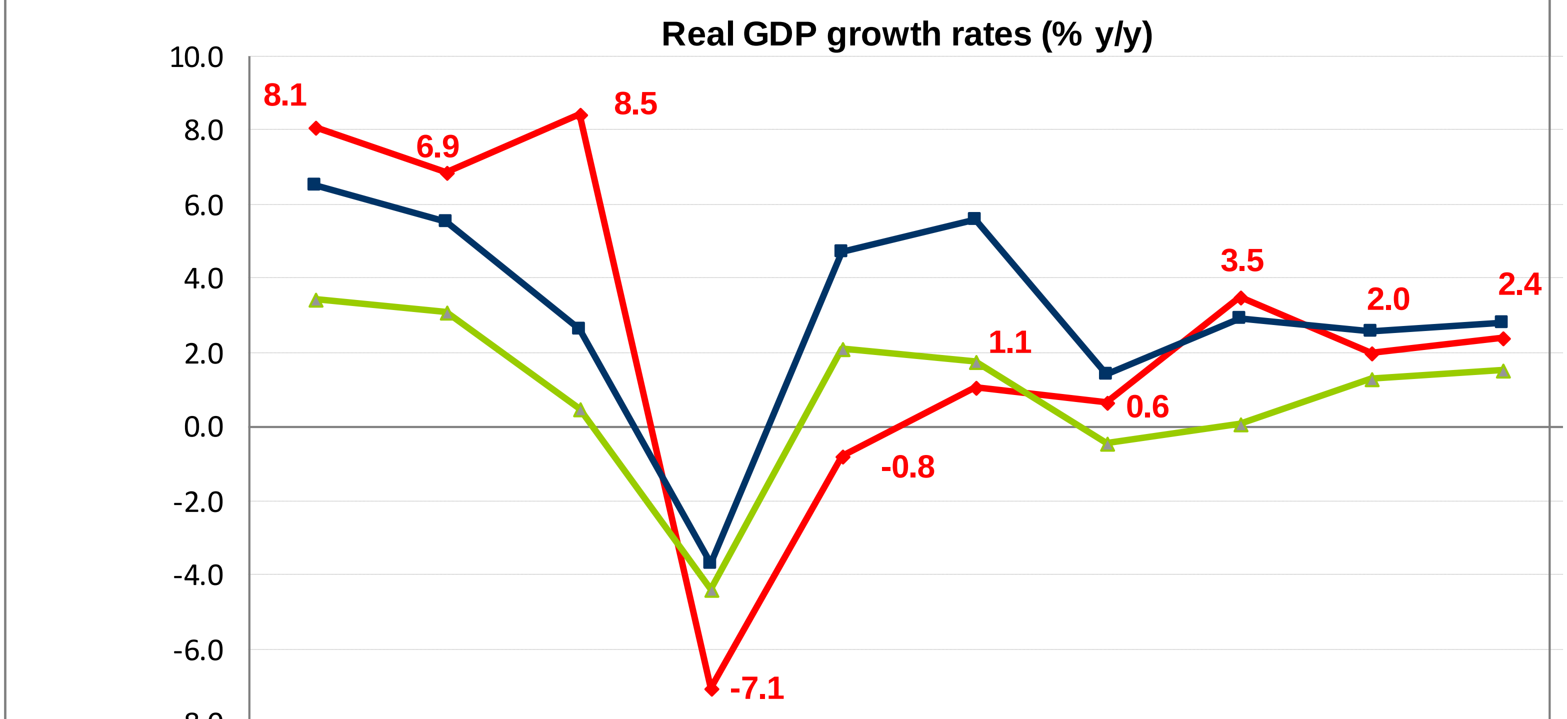
1. Preliminary remarks

- A change of paradigm
- Breakdown of models
- Banking (finance) reform
- What central banks are supposed to do
- The fear of secular stagnation
- EU crisis
- An age of uncertainty

2. Romania: huge correction of imbalances

- A liquidity squeeze during 2008/2009, like other NMSs (high external deficits; big private borrowing); IMF and EU assistance for EU member states with different ER arrangements
- Massive correction of external deficits: the current account deficit went down to 0.8% of GDP in 2013 (from a double digit level during 2007-2008); the role played by markets' freeze and upsurge of exports
- Massive correction of fiscal imbalance during 2010-2013; the role of agreements with the EC and IFIs
- Inflation at 1.6% at the end of 2013; in 2014 inflation is likely to be nearby
- Economic growth is forecast at cca. 2.5% in 2014 (from 3.5% in 2013, which was influenced by agricultural output) and a similar figure in 2015
- Public debt trebled, buy it is stabilizing around 40% of GDP.
- Fed's tapering of its stimulus finds Romania much better prepared than during 2008/2009 turbulences: correction of imbalances and "buffers"

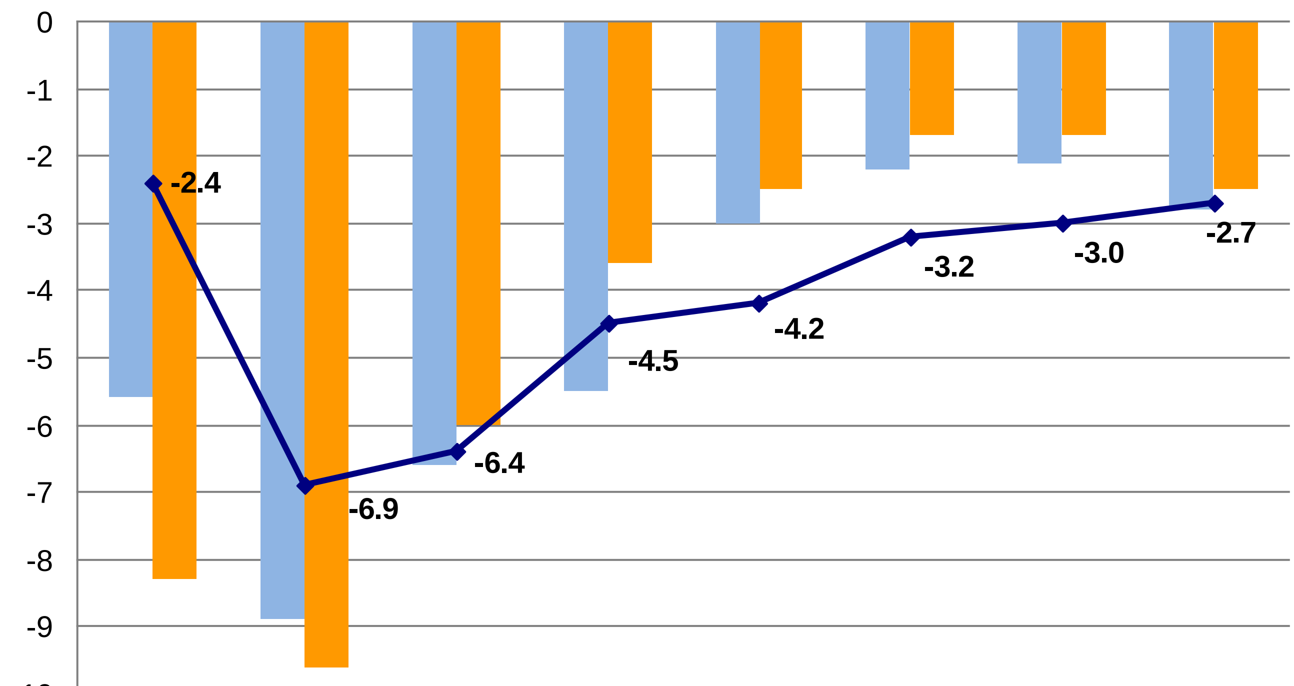
Romanian economy: real GDP growth



	2006	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
GDP RO	8.1	6.9	8.5	-7.1	-0.8	1.1	0.6	3.5	2.0	2.4
CEE	6.5	5.5	2.6	-3.7	4.7	5.6	1.4	2.9	2.6	2.8
GDP EU28	3.4	3.1	0.5	-4.4	2.1	1.7	-0.4	0.0	1.3	1.5

CEE; RO; EU 28; Source: European Commission (AMECO), Own calculations
(Bulgaria, Croatia, Hungary, Latvia, Lithuania, Former Yugoslav Republic of Macedonia, Montenegro, Poland, Romania, Serbia, Turkey)
2014 – 2015 Source: European Commission, Autumn forecast 2014
ESA 2010 methodology

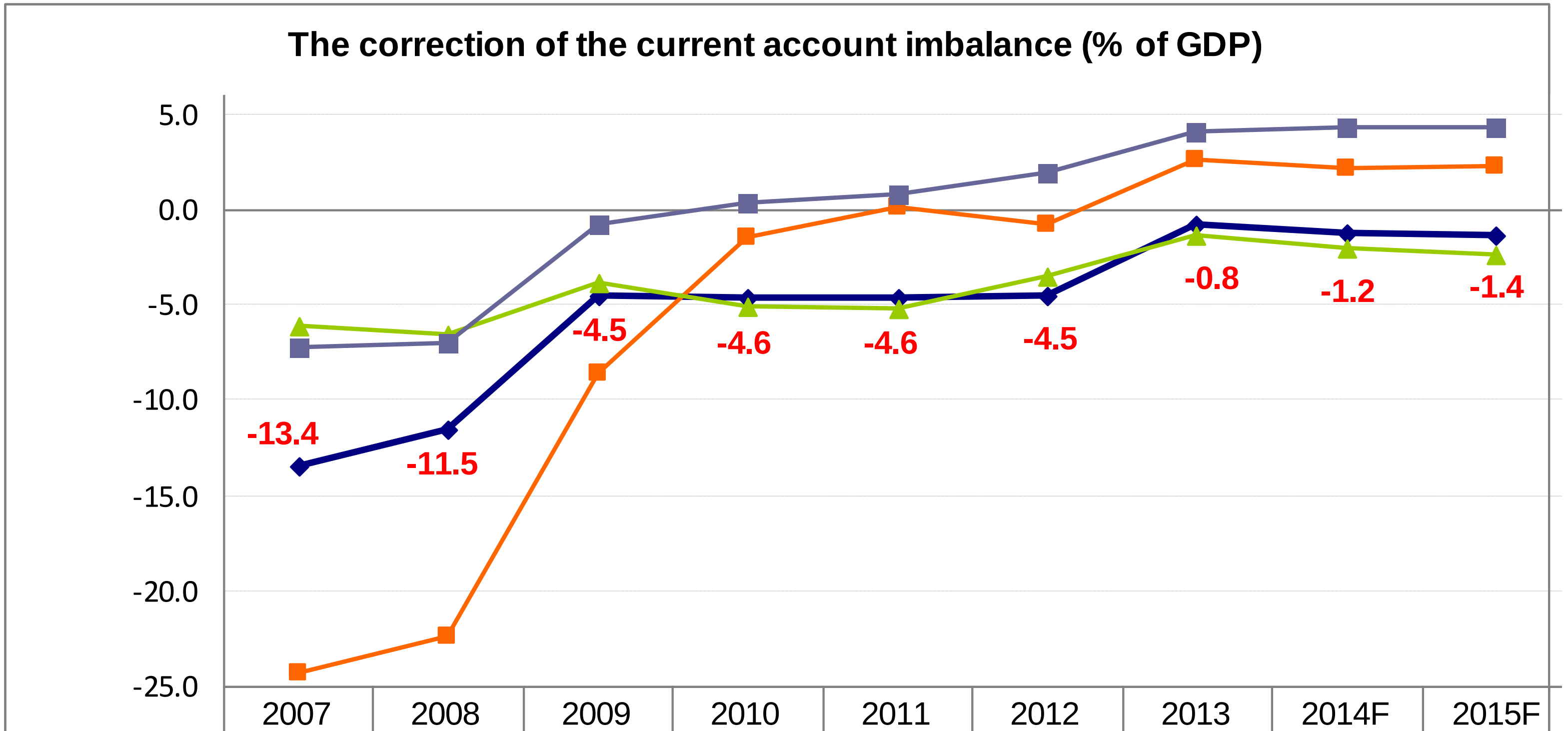
Romanian economy: fiscal consolidation



	2008	2009	2010	2011	2012	2013	2014F	2015F
Ro ESA95	-5.6	-8.9	-6.6	-5.5	-3.0	-2.2	-2.1	-2.8
Ro Structural	-8.3	-9.6	-6.0	-3.6	-2.5	-1.7	-1.7	-2.5
EU 28 ESA95	-2.4	-6.9	-6.4	-4.5	-4.2	-3.2	-3.0	-2.7

RO, EU 28 (Net lending (+) / borrowing (-)); RO (Structural budget balance)
Source: European Commission, Autumn forecast 2014; ESA 2010 methodology

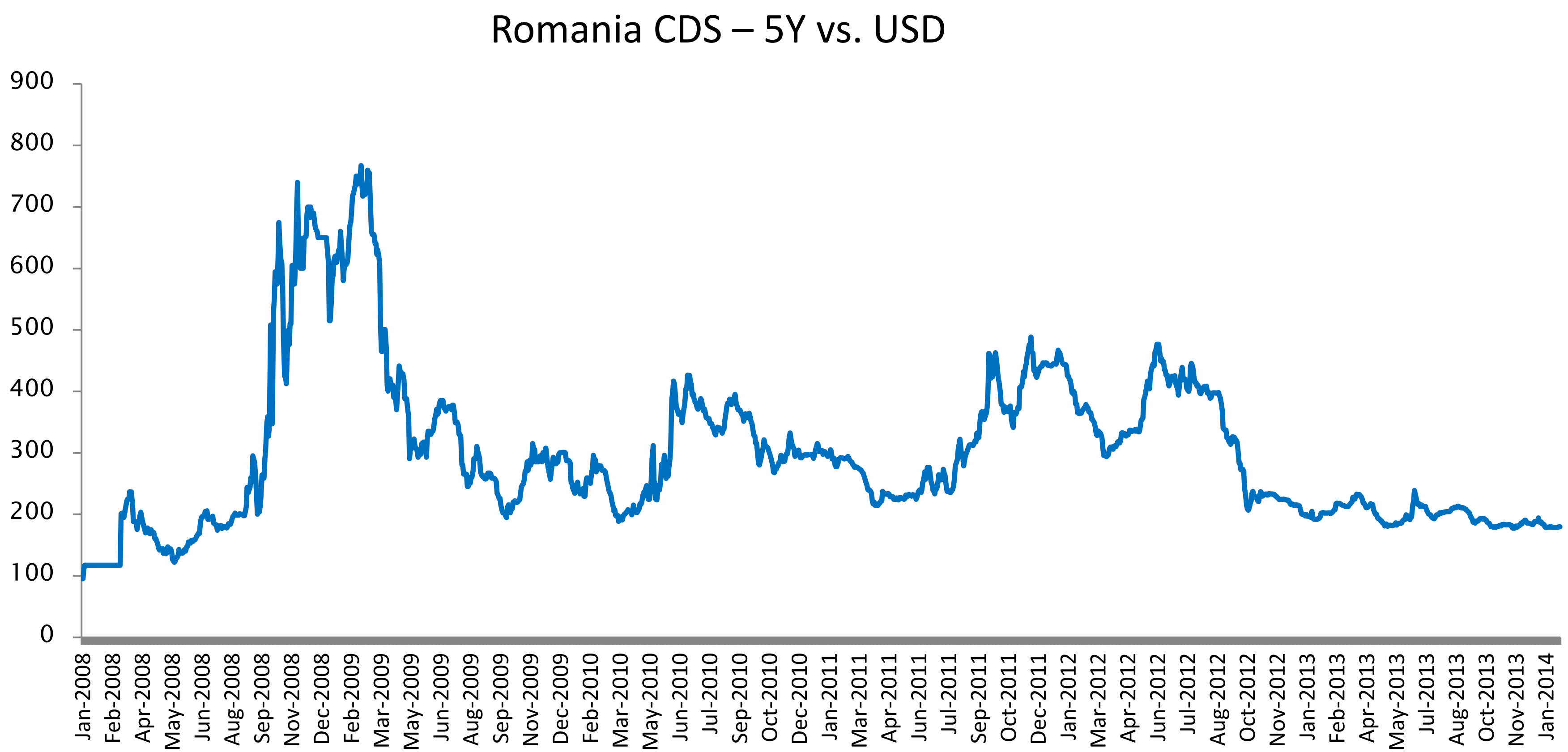
Romanian economy: major correction of the current account deficit



	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Romania	-13.4	-11.5	-4.5	-4.6	-4.6	-4.5	-0.8	-1.2	-1.4
Bulgaria	-24.3	-22.4	-8.6	-1.5	0.1	-0.8	2.6	2.1	2.3
Poland	-6.1	-6.5	-3.9	-5.0	-5.2	-3.5	-1.3	-2.0	-2.4
Hungary	-7.2	-7.0	-0.8	0.3	0.8	1.9	4.1	4.3	4.3

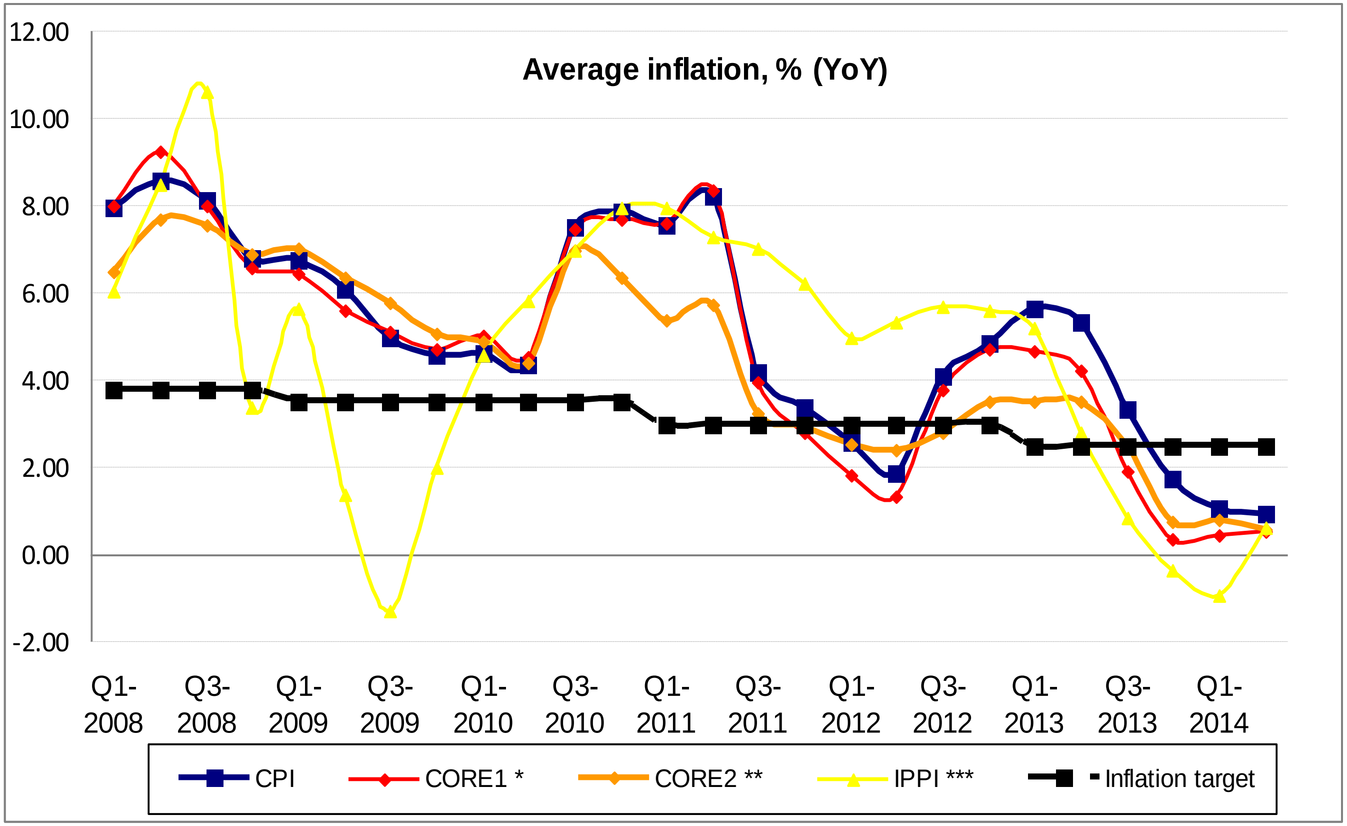
Source: Eurostat, European Commission, Autumn forecast 2014
BPM6 methodology: Romania, Poland (2011-2015), Hungary
GDP - ESA2010

Romanian economy: risk perception



Source: Reuters Datastream

Disinflation in Romania

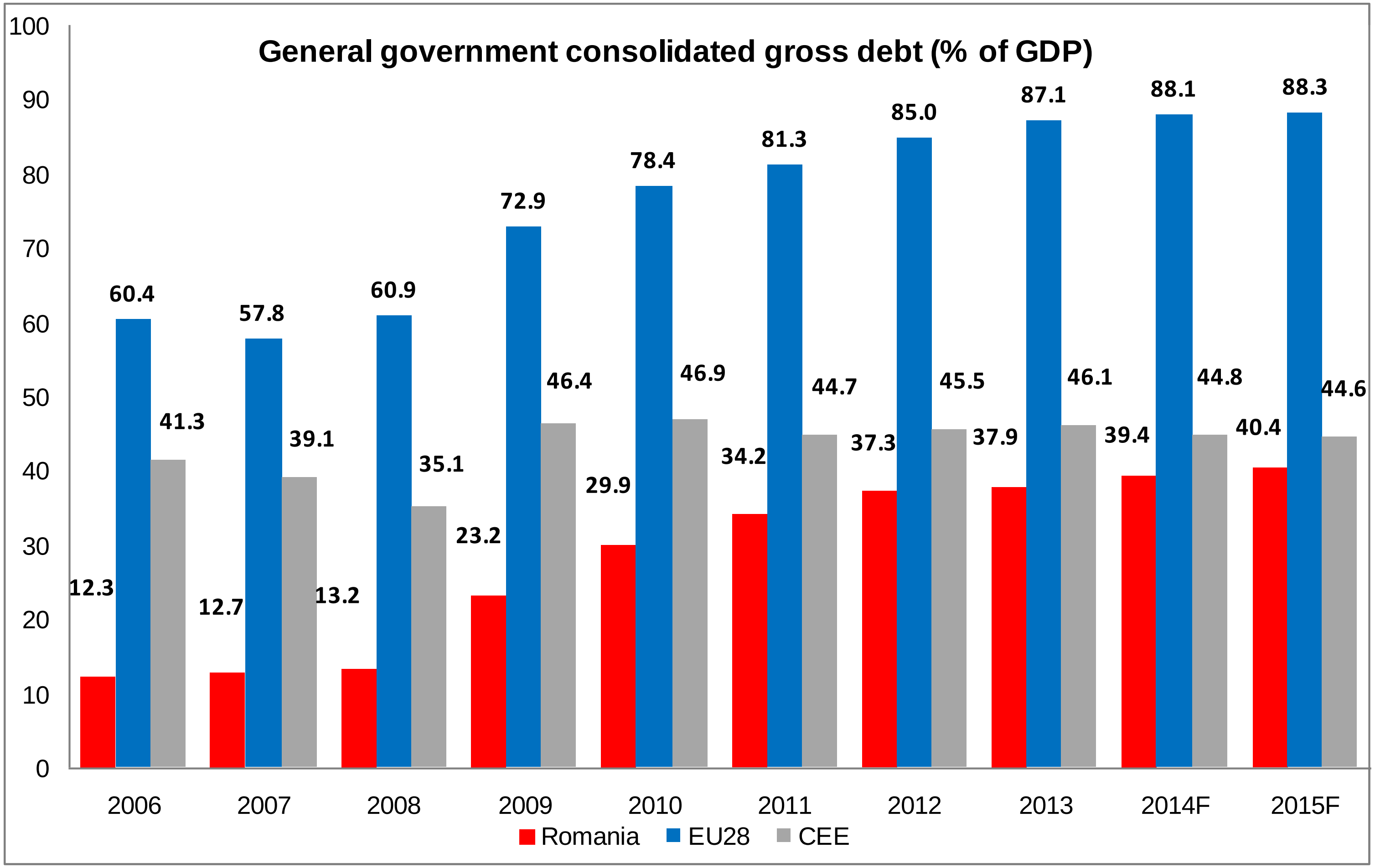


Source: National Institute of Statistics, NBR;

*CPI minus administered prices; **CORE1 minus volatile prices (vegetable, fruit, eggs, fuels)

***Industrial production price index

Romanian economy: public debt has been stabilizing at cca. 40 % of GDP



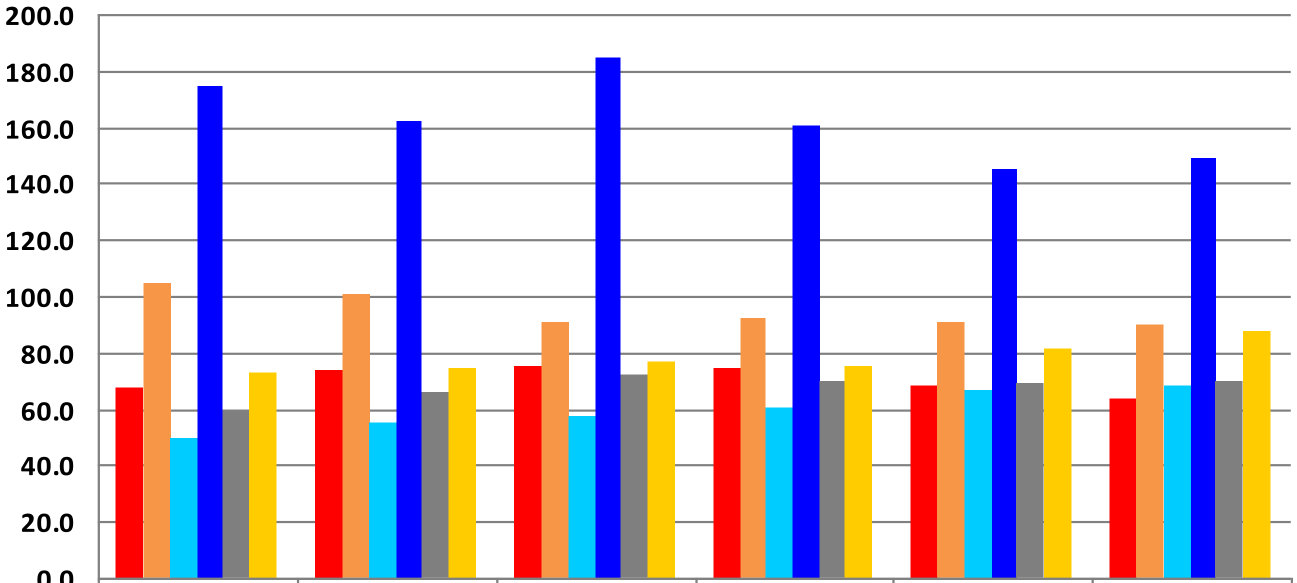
CEE; RO; EU 28; Source: European Commission (AMECO), Own calculations *(Bulgaria, Croatia, Hungary, Latvia, Lithuania, Former Yugoslav Republic of Macedonia, Montenegro, Poland, Romania, Serbia, Turkey)*

2014 – 2015 Source: European Commission, Autumn forecast 2014

ESA 2010 methodology (data for the EU28 is calculated on a non-consolidated basis)

Romanian economy: gross external debt at the low end in the region

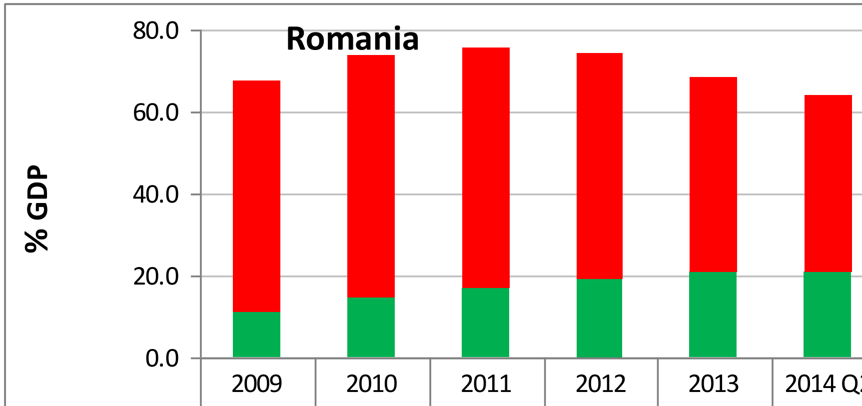
Gross External Debt * (% of GDP)



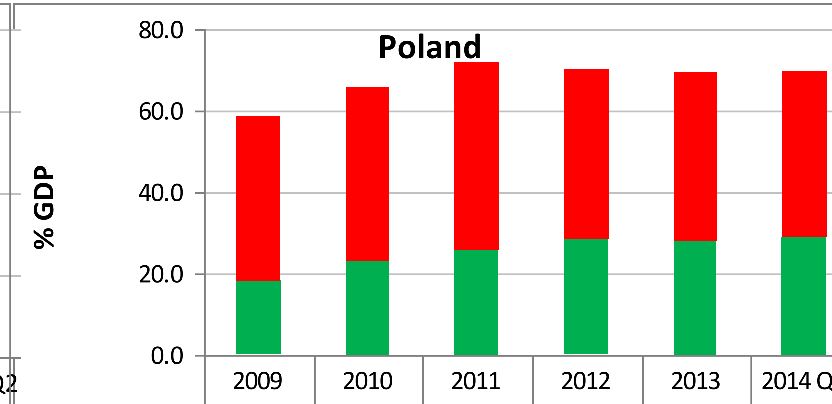
	2009	2010	2011	2012	2013	2014 Q2
Romania	67.4	73.8	75.5	74.2	68.6	63.9
Bulgaria	104.8	100.7	90.5	92.1	91.0	89.9
Czech Rep.	49.9	54.7	57.5	60.2	66.3	68.2
Hungary **	174.2	162.1	184.5	160.5	144.9	148.6
Poland	58.7	65.9	71.8	70.1	69.4	69.8
Slovacia	72.9	74.3	76.7	74.9	81.2	87.3

Source: National Central Banks, Own calculations, ESA 2010 methodology
* Romania (2013-2014), Czech Republic, Hungary, Poland: According to BPM6 Methodology; ** including SPE's

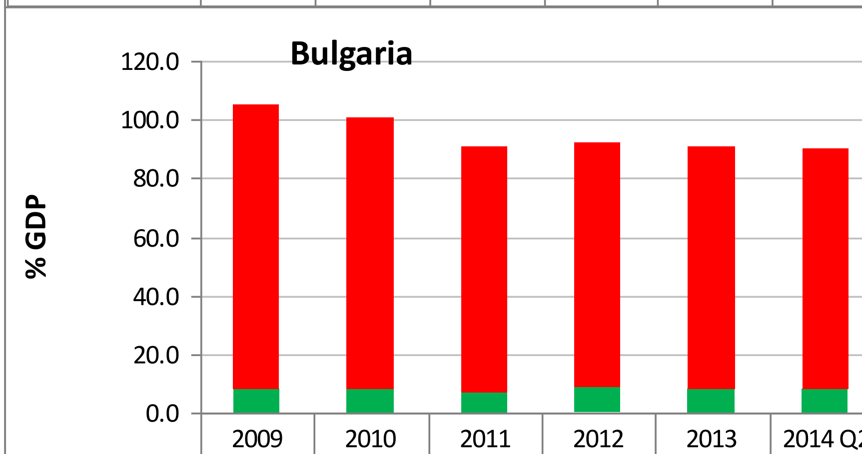
Romanian economy, external debt: public vs. private sector



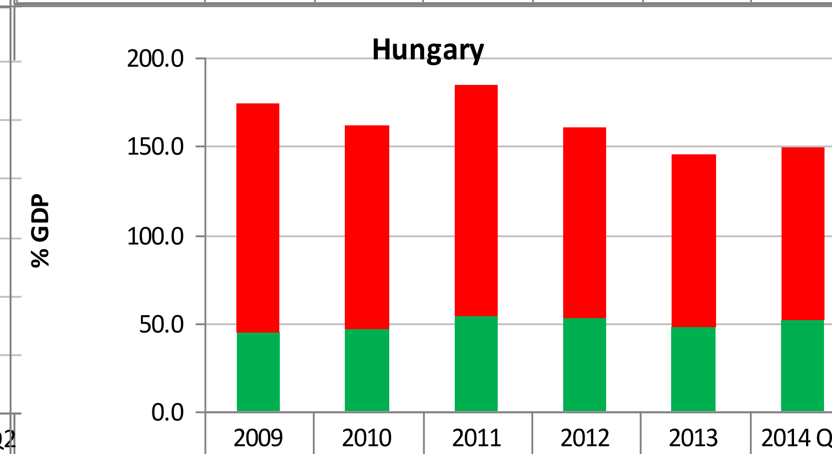
	2009	2010	2011	2012	2013	2014 Q2
Other sectors	56.1	59.0	58.5	55.2	47.7	42.8
Government	11.3	14.8	17.1	19.0	20.9	21.1



	2009	2010	2011	2012	2013	2014 Q2
Other sectors	40.5	42.9	46.1	41.5	41.5	41.2
Government	18.2	23.0	25.7	28.6	27.9	28.8



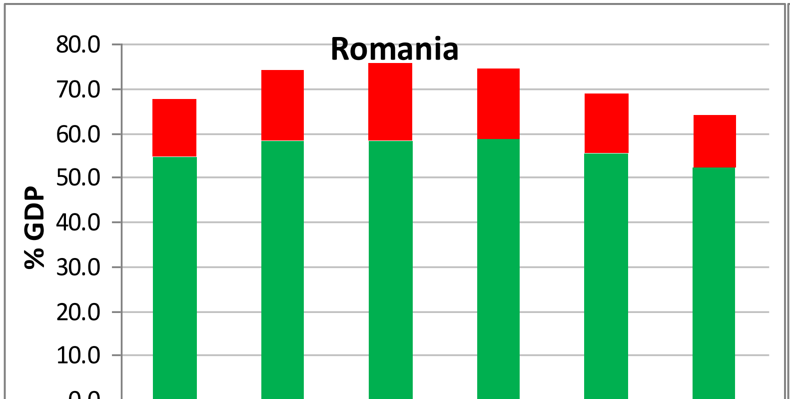
	2009	2010	2011	2012	2013	2014 Q2
Other sectors	97.0	92.9	83.6	83.4	82.6	81.5
Government	7.8	7.8	7.0	8.7	8.3	8.3



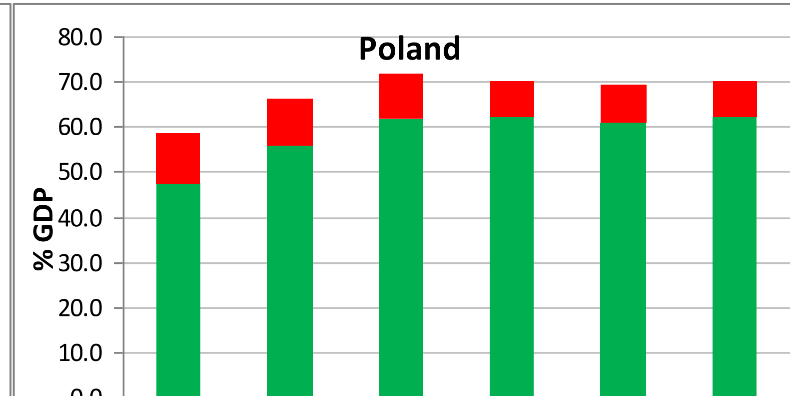
	2009	2010	2011	2012	2013	2014 Q2
Other sectors	129.1	115.3	130.5	107.8	97.0	97.9
Government	45.0	46.8	54.0	52.7	47.9	51.4

Source: National Central Banks, Own calculations,
ESA 2010 methodology
Romania (2013-2014), Czech Republic, Hungary, Poland: According to BPM6 Methodology

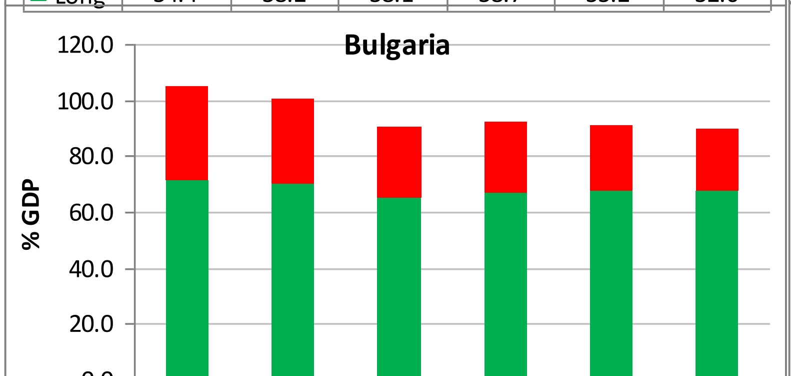
Romanian economy, external debt: short-term vs. long-term debt



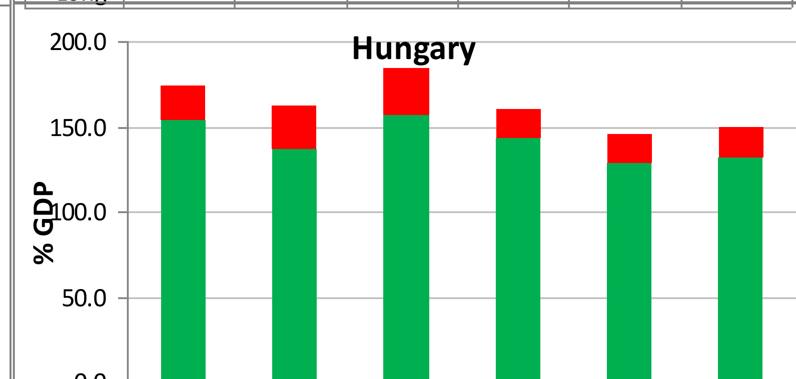
	2009	2010	2011	2012	2013	2014 Q2
Short	12.9	15.6	17.4	15.6	13.4	11.9
Long	54.4	58.2	58.1	58.7	55.2	52.0



	2009	2010	2011	2012	2013	2014 Q2
Short	11.3	10.0	9.9	8.1	8.4	7.7
Long	47.3	55.9	61.9	62.0	61.0	62.3



	2009	2010	2011	2012	2013	2014 Q2
Short	33.6	30.5	25.2	25.3	23.3	22.1
Long	71.2	70.3	65.3	66.8	67.7	67.8



	2009	2010	2011	2012	2013	2014 Q2
Short	20.6	25.3	27.4	17.8	16.7	17.4
Long	153.6	136.8	157.0	142.7	128.3	131.8

Source: National Central Banks, Own calculations, ESA 2010 methodology
Romania (2013-2014), Czech Republic, Hungary, Poland: According to BPM6 Methodology

3. Older vintage policy issues

- "Structural strain": how to deal with massive resource misallocation (analogy with overburdened monetary policy during the current crisis)
- The persistence of high inflation (role of expectations, moral hazard, the exchange rate pass-through); the move to "inflation targeting" in 2005 (inflation expectations were deeply entrenched…)
- Pace of financial liberalization

3.1. Financial liberalization

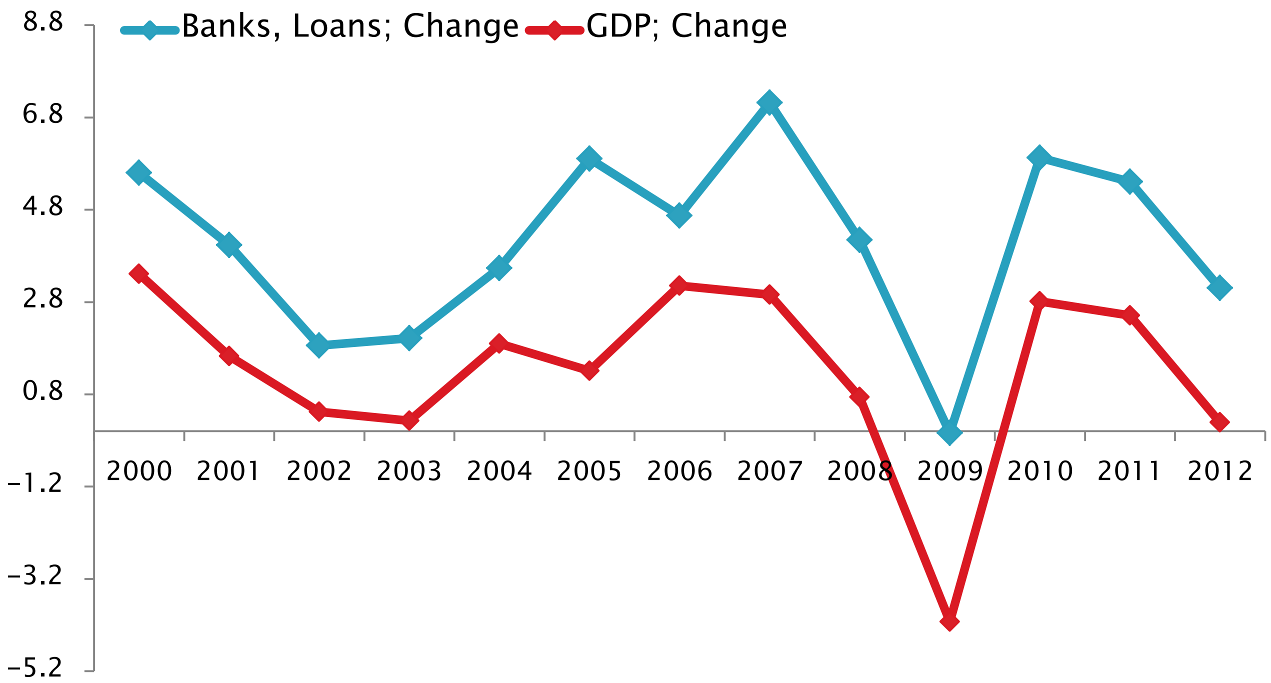
- Financial (capital account) liberalization and the "Tosovsky dilemma"; an intense debate
- The EU rules of the game (the single market and KAL) have enhanced a boom and bust cycle (see graphs): the impossible trinity (trilemma) is a "dilemma" (Helene Rey)
- The interplay between the global financial cycle and the European financial cycle + inadequate international arrangements
- NBR's efforts to stem the skyrocketing pace of credits of little avail: euroization and parent funding…

3.1. Financial liberalization: the European financial cycle

- Boom and bust did occur in large parts of the EU (see graphics)
- The importance of private borrowing in judging resilience to shocks (BoP crises)
- Romania faced a liquidity crisis because of markets' freeze: the role of EU/IMF financial support and the Vienna Initiative
- In CESEEs public debts and private debts are much lower than in most of the EU: is there a puzzle with credit? Deleveraging…

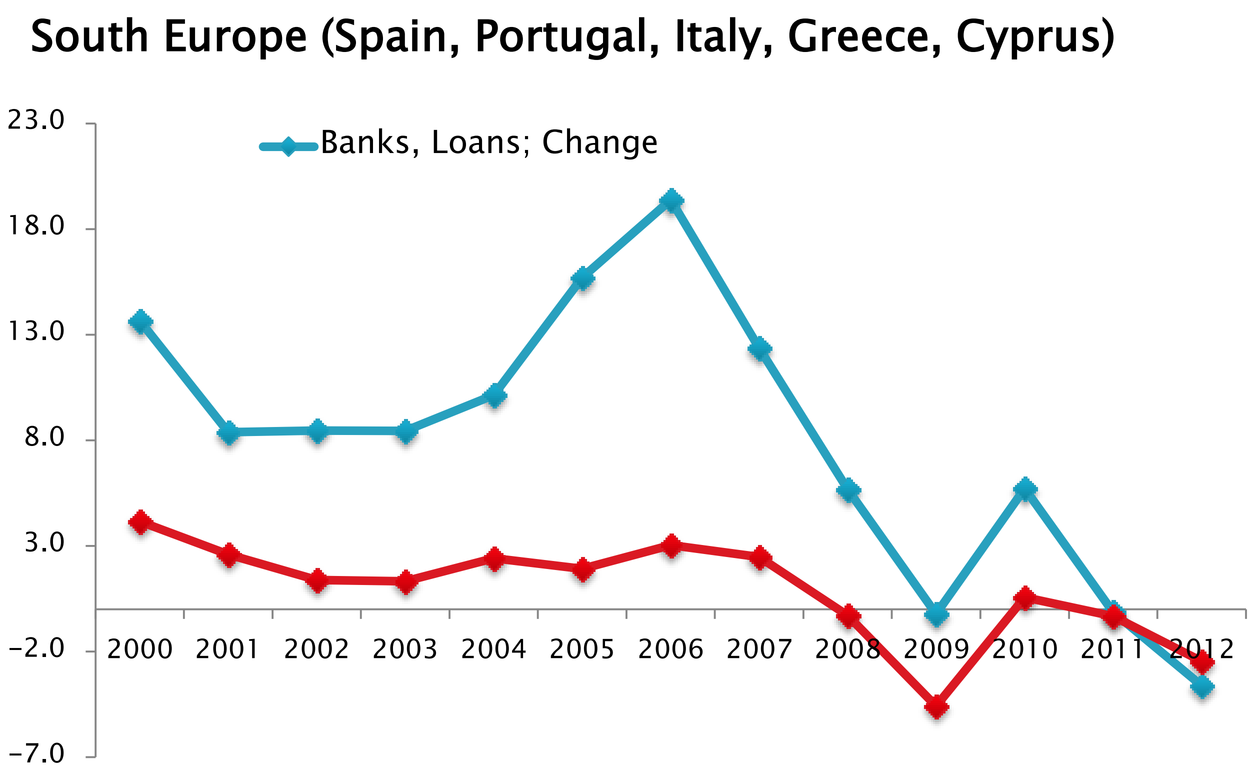
Economic growth and bank lending

Central West Europe (Belgium, Germany, France, Netherlands)



Source: Eurostat, European sector accounts (Central bank; other monetary financial institutions), Own calculations

Economic growth and bank lending



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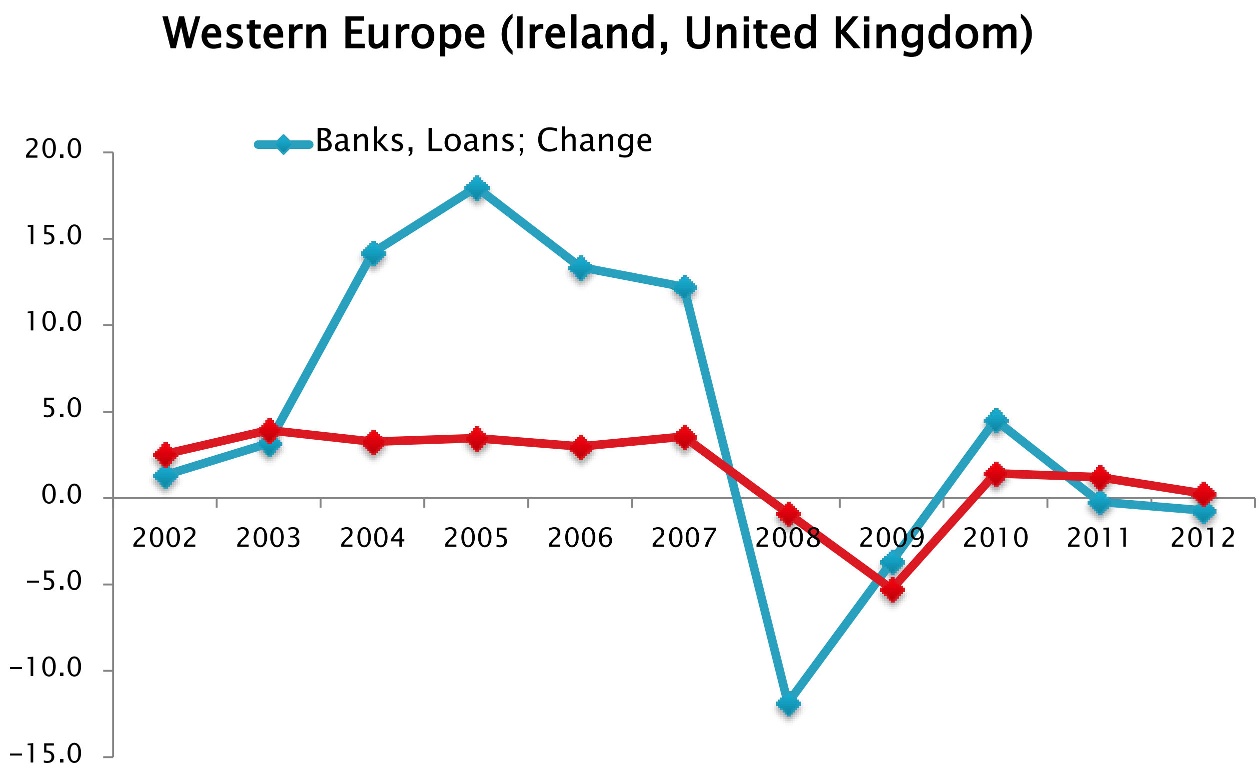
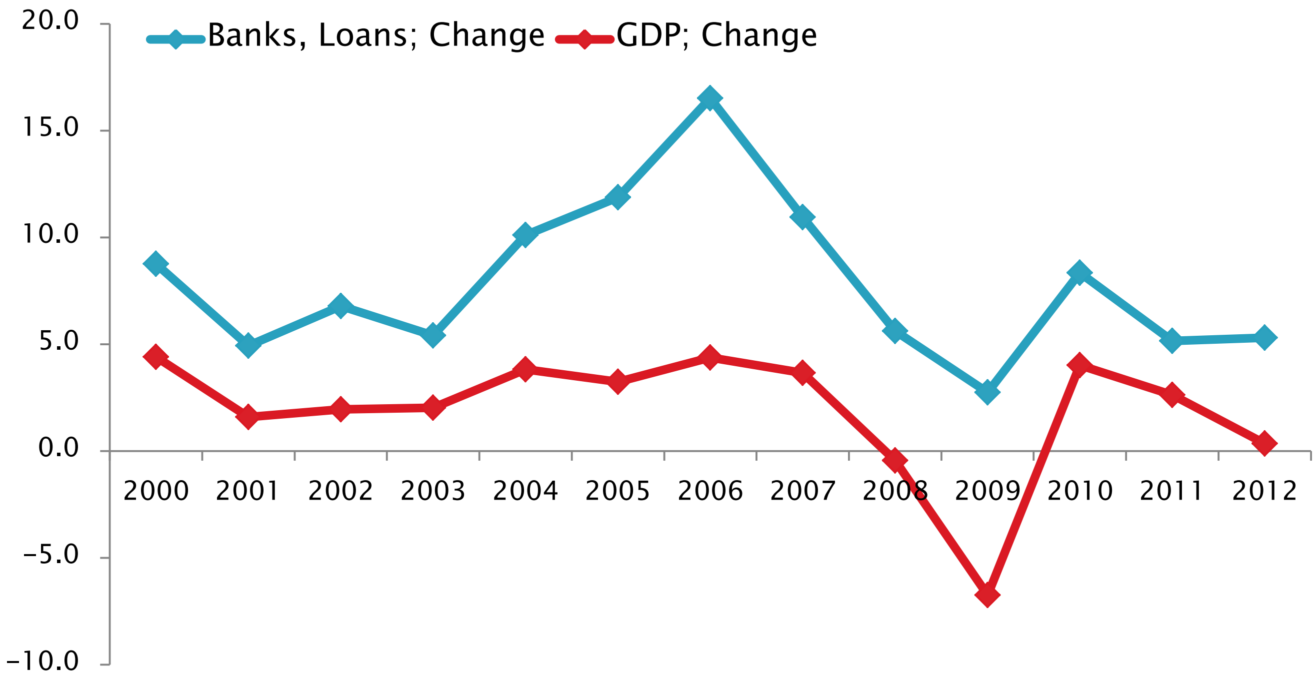
Economic growth and bank lending



Source: Eurostat, European sector accounts (Central bank; other monetary financial institutions), Own calculations

Economic growth and bank lending

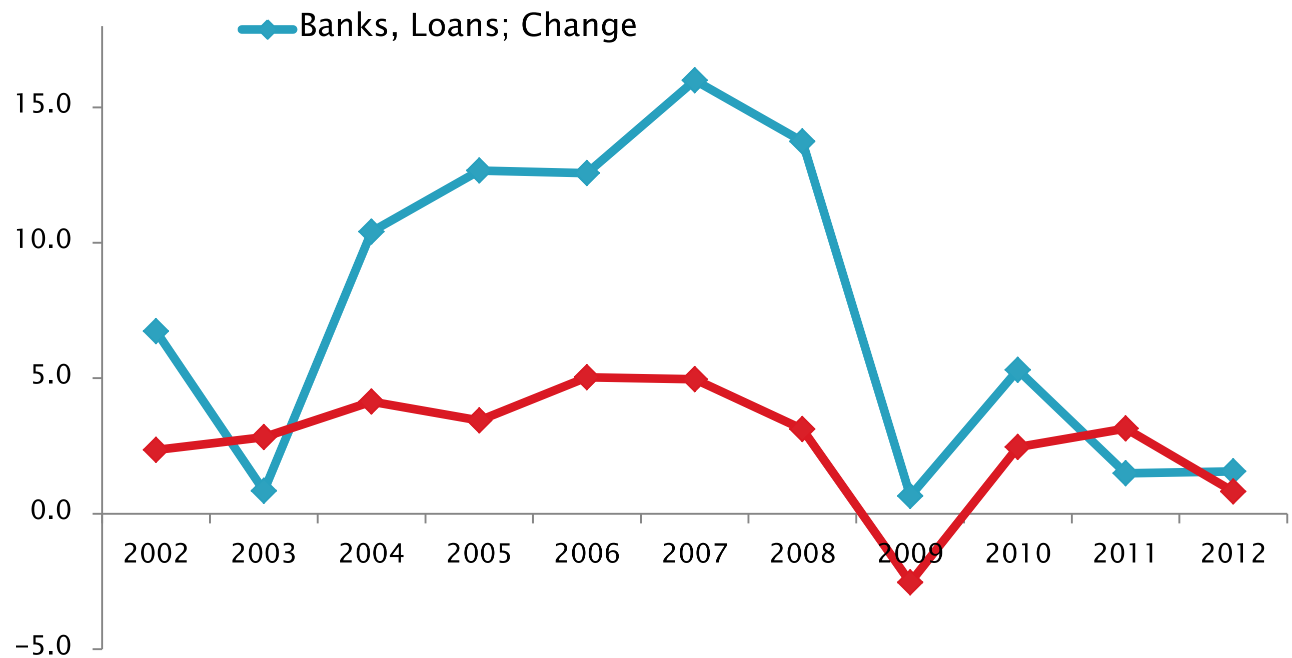
Northern Europe (Finland, Sweden, Estonia, Latvia, Lithuania, Denmark)



Source: Eurostat, European sector accounts (Central bank; other monetary financial institutions), Own calculations

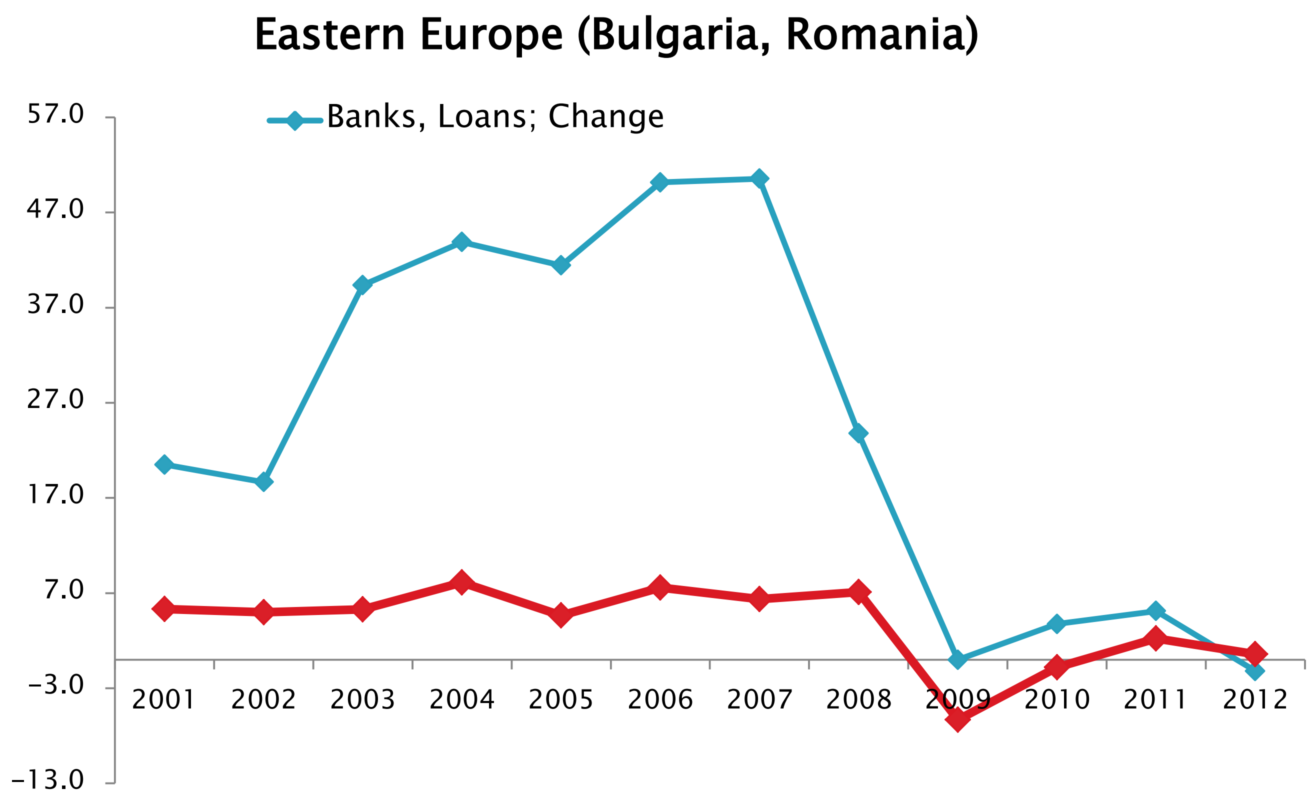
Economic growth and bank lending

East Central Europe (Croatia, Hungary, Austria, Poland, Slovenia, Slovakia)



Source: Eurostat, European sector accounts (Central bank; other monetary financial institutions), Own calculations

Economic growth and bank lending



Source: Eurostat, European sector accounts (Central bank; other monetary financial institutions), Own calculations

3. Which type of inflation targeting?

- Macroeconomic policy in a small open economy
- The choice for a “light” (flexible) IT
- Managed floating (allowing the Ron to appreciate to 3.1/1 euro was suboptimal…)
- The euroization impact on MP: the balance-sheet (wealth) effect due to exchange rate dynamics
- NBR cannot be complacent about big exchange rate gyrations (inflation, financial stability (balance-sheet effect))
- Deleveraging and GDP dynamics

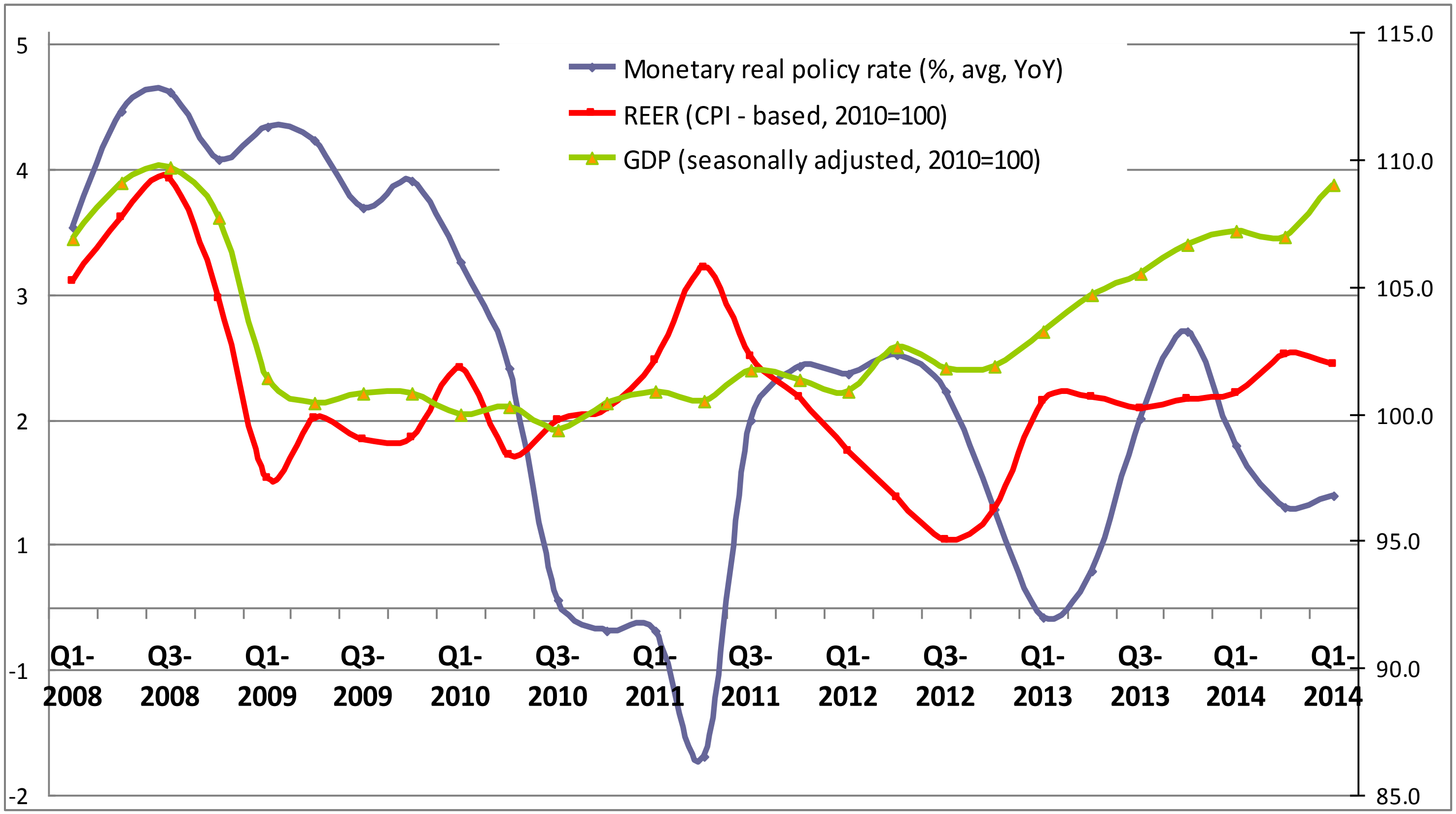
3. “Light” Inflation Targeting

- The transmission mechanism operates, though with difficulty (lending rates); credit supply and demand constraints are high (high indebtedness?): is creditless recovery possible?
- IT relies also on administrative tools (RR for both euro and Ron funds)
- Macroprudential tools: they operated during 2006-2008, but with little efficacy

3. “Light” Inflation targeting

- Disinflation has occurred, but with large deviations from target (due to various, mostly supply shocks); large negative GDP gap after the crisis hit has helped disinflation
- Fiscal policy was pro-cyclical after 2009 due to the forex constraint and the big structural budget deficit. The Monetary Policy easing was restrained because of ER depreciation fear. Why GDP bounced back though?
- Export dynamics were key in recent years; REERs and productivity gains

3. Real IRs, REERs, GDP dynamics…



Source: National Institute of Statistics, NBR; REER – European Central Bank

3. A key trade-off

- The stimulus entailed by a less tight MP is counteracted by the wealth effect induced by an exchange rate depreciation (inflation and the balance-sheet impact)
- The impact of monetary conditions
- When the transmission mechanism breaks down lower policy rates are less effective (credit demand and supply constraints)

4. Recent vintage dilemmas: A new age?

- An age of uncertainty
- A paradigm shift (price stability is not sufficient for economic stability)
- Finance as an in-built destabilizer: the trilemma “is a dilemma, stupid”
- A breakdown of models: how to model non-liniarities (tail events)
- Proliferation of extreme (tail) events/shocks
- Complexity on the rise and inability to understand it frequently
- An over-burdening of central banks’ functions
- Central banks can no longer rely on simple rules
- Prospects of much lower growth in the industrialized world (a balance-sheet recession, SecStag, very time consuming in its healing)
- Social and political implications of economic slowdown/recession
- Ineffective international policy coordination
- A decline in robustness and resilience

4. Dilemmas of recent vintage: a new environment

- The eurozone is, arguably, no longer menaced by a collapse (ECB's actions and large macro-imbalance corrections in its periphery), but…
- Specter of debt deflation in the eurozone;
- The link between sovereign debt and bank balance-sheets has not been severed;
- Fragmentation of markets (although the periphery pays much less for issuing its debt…)
- Internal demand is very weak suffering from the negative loops between weak activity, fragile banks, weak firms, diminished incomes, and the need for fiscal consolidation
- The bottom line: how to foster economic growth?
- The breakdown of the growth model that relies on heavy capital imports
- The fallout from the Ukraine crisis on economic recovery in Europe (geopolitical risks); other geopolitical risks (The Arab world…)
- Capital flows reversals (risk aversion)
- Fed's tapering of its stimulus

4. Dilemmas of recent vintage

- **The policy space** issue (apart from fiscal space)
- Diminishing inflation has allowed a relaxation of the monetary policy rate to 2,75% in November 2014; there is room to continue easing by reducing the policy rate and reserve requirements; caution in view of Fed's tapering impact, the balance-sheet effect and a prospective rise of inflation in the second half of 2015
- A threat of the zero lower bound in Romania? Highly improbable in the near future…

4. Dilemmas of recent vintage

- Does joining the Banking Union make sense?
- How to manage monetary policy and financial stability policy in a central bank
- The need to develop capital markets
- More local banks?
- Rethinking the growth model (fostering comparative/competitive advantages)
- Joining the euroarea is a political commitment and decision; the euroarea needs to solve its problems and Romania's economy become stronger

4. Dilemmas of recent vintage

- Macro-prudential considerations will play an increasing role in the conduct of macroeconomic policy: the pluses and minuses of deep financial markets (size of economy, participation of domestic investors, *the international policy regime*)
- The governance of the eurozone? Its fiscal underpinnings are very precarious
- The reform of the banking (financial sector): size; its speculative nature; shadow banking sector (the return to Glass Steagal does make sense)
- The big players' role in global and European financial cycles; do they care about the externalities they produce? A new Bretton Woods is needed (international policy coordination): conceptual issues; avoiding the "dark corners" (O. Blanchard)

Thank You