Dealing with Shocks at the Gates of the EU: new monetary policy instruments and the role of central banks

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Dealing with Shocks at the Gates of EU

New Policy Instruments
&
The Role of Central Banks

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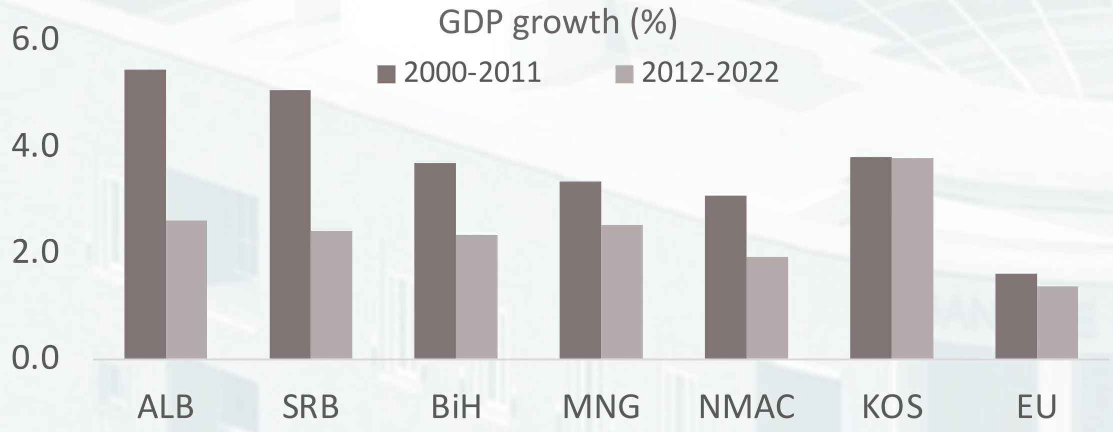
1. The Western Balkans

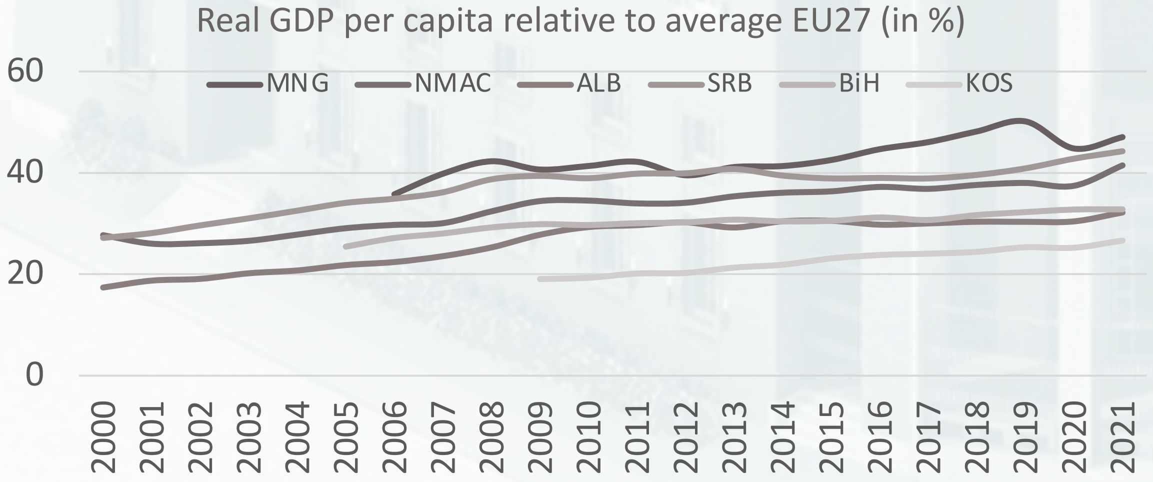
1. The Western Balkans

Country	Population (in millions)	GDP per Capita		Currency	FX Regime	EU Membership Status
		Nominal (euros)	*Relative to EU*			
Albania	2.8	5390	32%	Lek	Floating	Candidate
Serbia	6.7	7760	44%	Serbian Dinar	Managed Floating	Candidate
North Macedonia	2.02	5677	41%	Macedonian Denar	Managed Floating	Candidate
Bosnia and Herzegovina	3.2	5420	33%	Convertible Marka	Currency Board	Potential Candidate
Montenegro	0.7	7906	47%	EURO	Unilateral adoption	Candidate
Kosovo	1.8	4166	n/a	EURO	Unilateral adoption	Potential Candidate

1. The Western Balkans

The WB region has had a steady, but somewhat slow, convergence to EU living standards





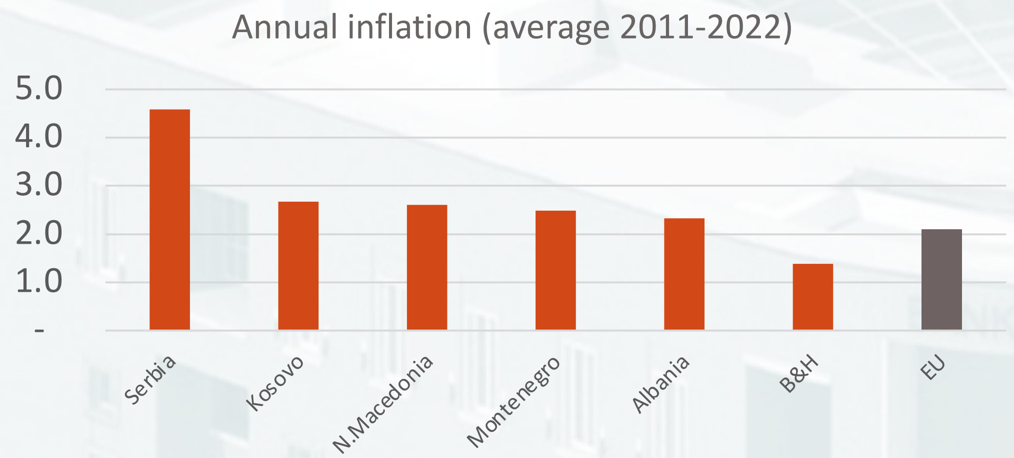
The real convergence of the WB has been:

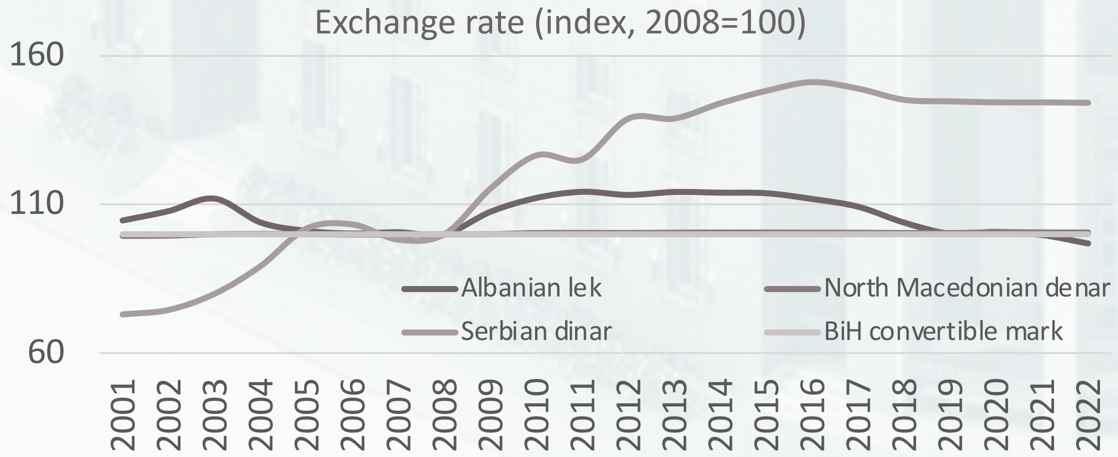
- **<u>Fast in the second decade of transition (2000-2011)</u>**, though unsustainable, because of:
  - A largely domestic demand-driven growth model;
  - Rapid rise of external debt and other financial vulnerabilities;
  - A slowing down of structural reforms.
- **<u>Slow in the third decade (2012-2022)</u>**, because of:
  - A necessary restructuring of the business model;
  - Tighter external financial conditions.
- **<u>Rather insufficient</u>**, especially compared to better performing CEE countries

Source: National statistics institutes and central banks

1. The Western Balkans

But, in terms of nominal convergence, the WB performance has been better:





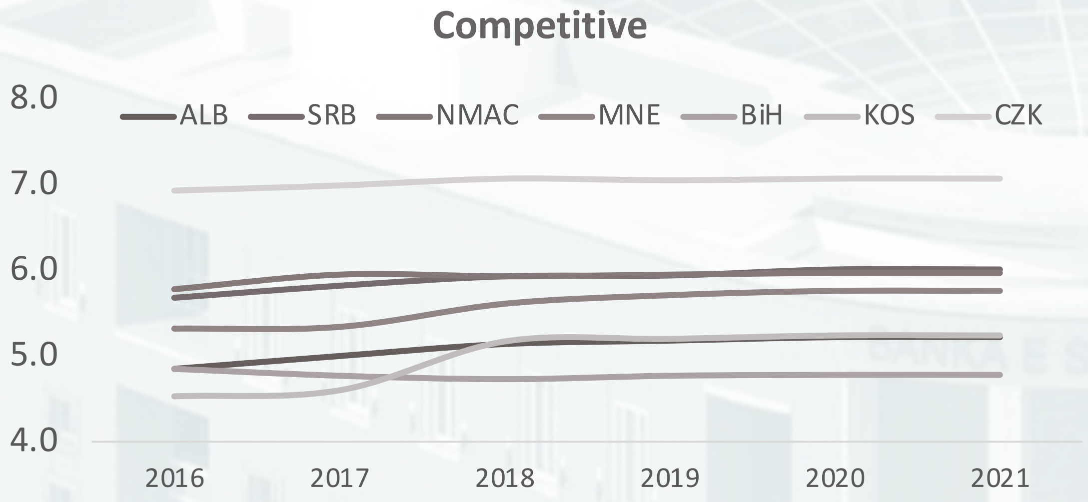
The WB has had **a faster rate of nominal convergence**

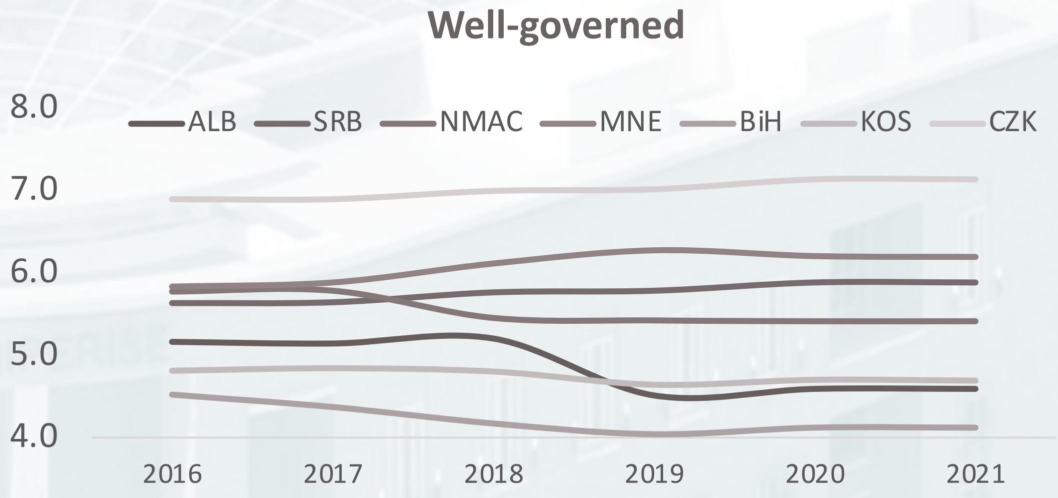
- **CPI inflation has been under control**, with average inflation on a decreasing trend and inflation volatility lower
  - Testament of improving / credible monetary frameworks
  - Providing a stronger domestic nominal anchor
- **Exchange rates have been rather stable**, indicating:
  - Absence of large scale BoP shocks
  - Decreasing risk premia in domestic financial markets

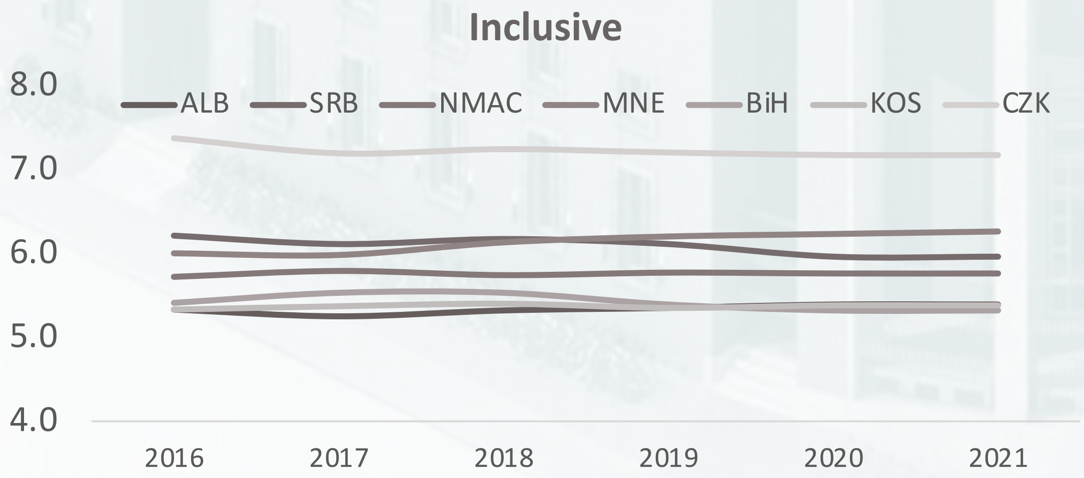
Source: National statistics institutes and central banks

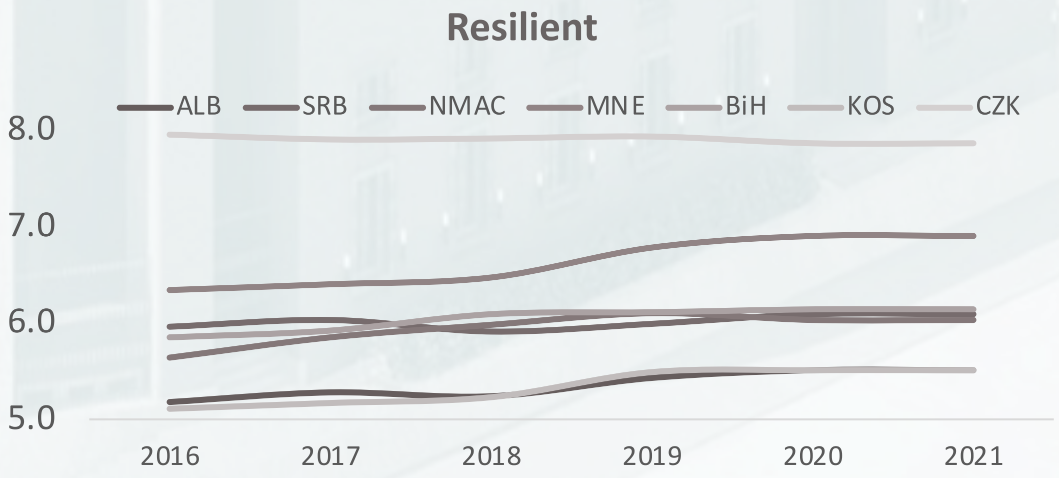
1. The Western Balkans

However, the region has still some way to go in terms of institutional convergence…









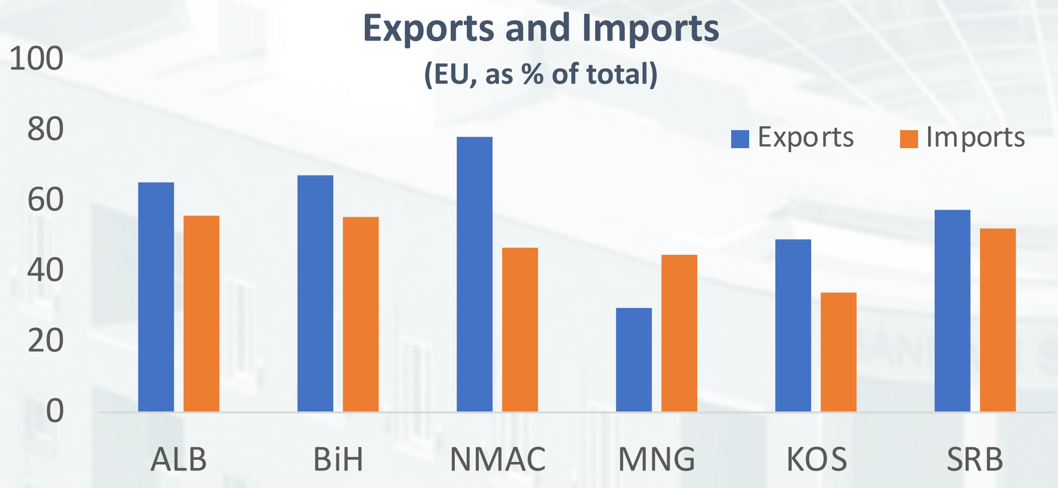
Source: EBRD Transition Report

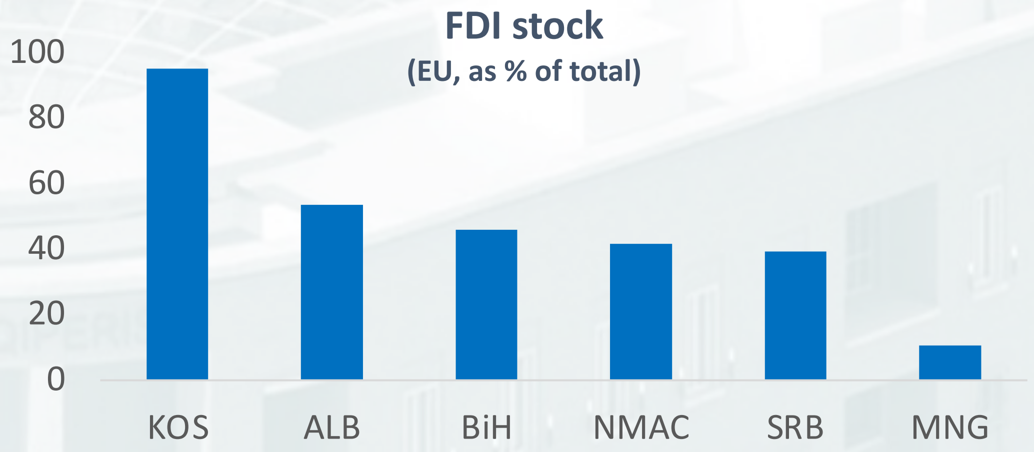
2. EU integration: a gravity-driven process

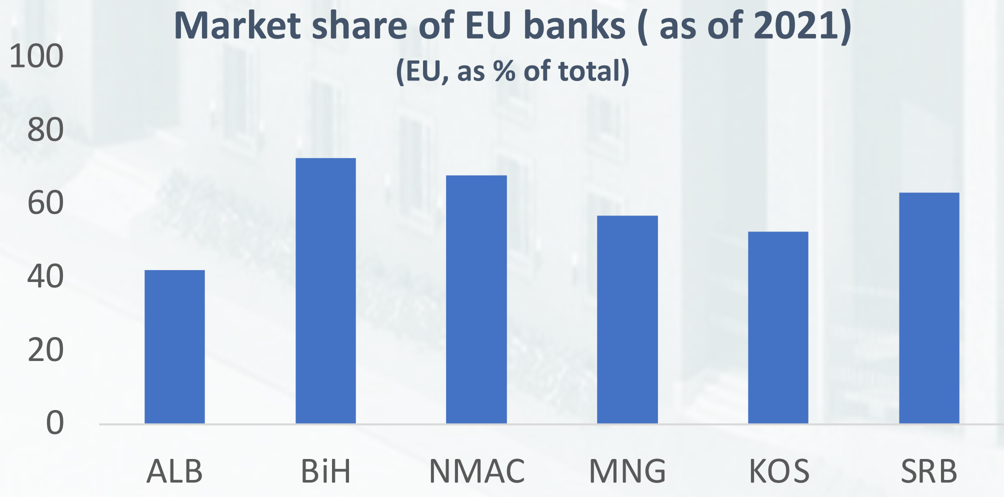
- EU membership is an aspiration driven by geographical, cultural and political reasons
- EU is amongst the top three largest economic and trading areas in the world
- EU is a global institutional & regulatory powerhouse
- EU is the main economic, trade and financial partner of the WB countries
  - **Economic integration:** EU is the largest source of FDIs & remittances, and largest destination of migration
  - **Trade integration:** EU accounts for more than 60% of overall external trade
  - **Financial integration:** EU is the single largest investor and financial partner

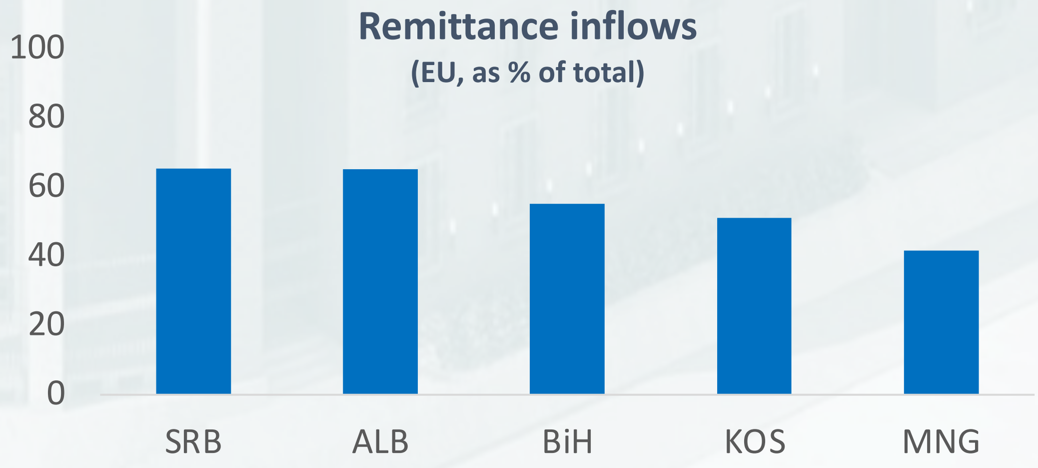
2. EU integration

WB6 economic and financial ties with EU









Source: National statistics institutes and central banks

2. EU integration

The EU is the biggest donor, investor and trading partner in the Western Balkans

No. 1 DONOR

The EU has committed over
€29.5 billion
since 2007

No. 1 INVESTOR

EU companies are by far the **leading investors**, accounting for
61% of FDI stock
in the region in 2021

No. 1 TRADING PARTNER

EU accounts for
almost 70%
of the region's **total trade** in 2021

The European Commission and the European Investment Bank
€3.3 billion
to tackle COVID-19 pandemic and socio economic recovery in the Western Balkans

Western Balkans is a market of over
17 million consumers

Source: EU – Western Balkan Relation Dec 2022, by EU Commission

2. EU integration process: ***Necessary***

- The EU integration process:
  - **Prepares** a candidate country for legal and institutional convergence
  - **Facilitates** regulatory alignment and policy dialogue
  - **Helps** in closing some of the nominal and real convergence gaps

- As transition economies, the process is necessary for WB6 countries, because it:
  - **Prepares** them to withstand competitive pressures in EU
  - **Mitigates** the risk of falling behind on the reform agenda

2. EU integration process: *Useful*

- The EU integration process serves as **an anchor of structural reforms**
  - It provides guidance and consistency to the reforms agenda
  - It helps building social and political consensus to the costs of reforms
- The EU integration process helps **attract private sector FDIs**
  - It reduces perceived political and legal risks amongst real and financial sector investors
- The EU integration process allows for **increased EU-funding** as it moves forward
  - Instrument of Pre-Accession (IPA) funds
  - Western Balkan Investment Funds
- The EU integration process helps **improve domestic business & investment climate**

2. EU integration process: *Challenging*

- **Prolongation of the process** from the EU might slow or stall EU integration

- **"Disappointment"** *from the* candidate country might decrease their appetite for the structural reforms

- The increased economic & financial integration **leads to an asymmetric exposure to risks**…
  - Economic & financial shocks
  - Policy and regulatory shocks

- … while not having any input on EU policies, or access to EU instruments (ESM)

3. Challenges and policy response

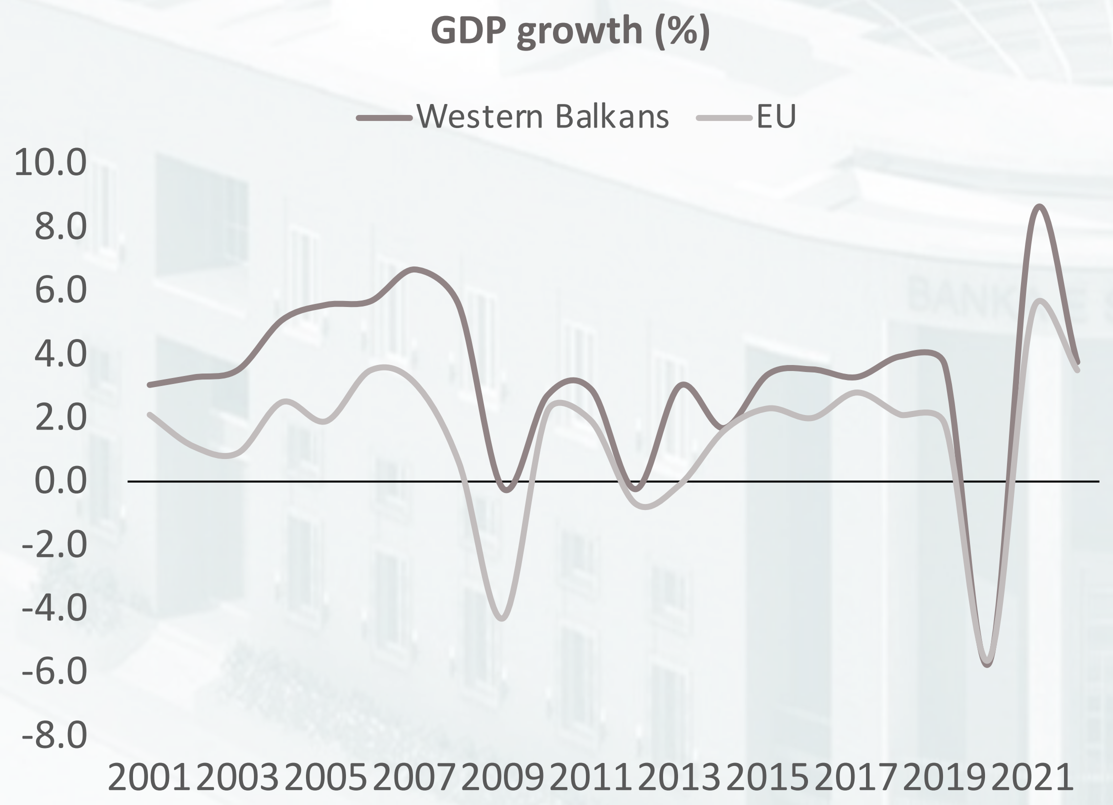
1. Dealing with EU induced asymmetric shocks

- Real shocks
- Financial shocks
- Policy / regulatory shocks

2. Policy response in Albania

3.1 Asymmetric shocks: ***Real shocks***

A large degree of trade & economic exposure opens the WB region to asymmetric risks...



Source: IMF, Eurostat

High economic exposure to EU means a large exposure of the WB to EU shocks

However, while EU-specific shocks affect the WB, the opposite is not true

For example:

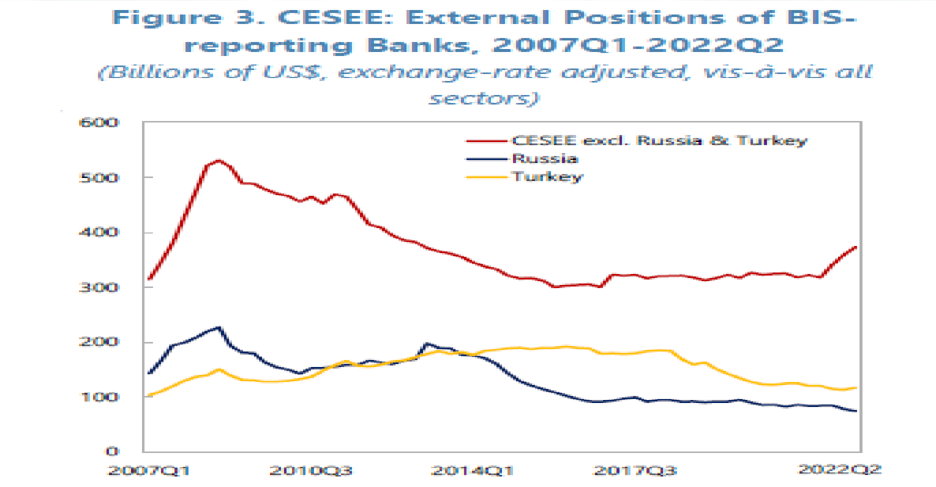
A negative demand shock in Albania would require an accommodative monetary policy stance from the BoA

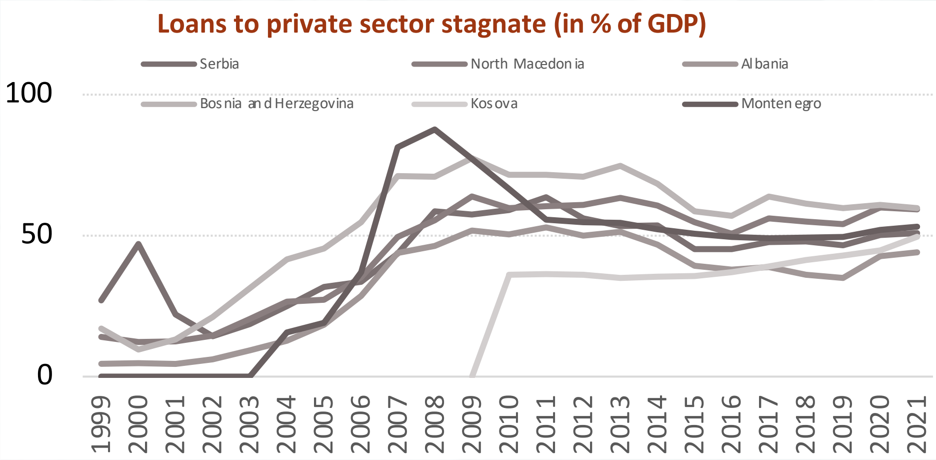
But, the ECB would not react in the same direction…

This would:
- decrease the effectiveness of monetary policy (because of high financial euroization)
- potentially expose the country to financial stability risks (if the exchange rate depreciates too much and affects un-hedged borrowers).

3.1 Asymmetric shocks: *Financial shocks*

High financial integration has a direct impact on the WB economies





Source: IMF, Eurostat

High financial integration means WB countries are exposed to EU financial cycles & EU regulatory practices

<u>The rapid GDP growth prior to GFC</u> was partly driven by the business model of EU banks, characterized by:

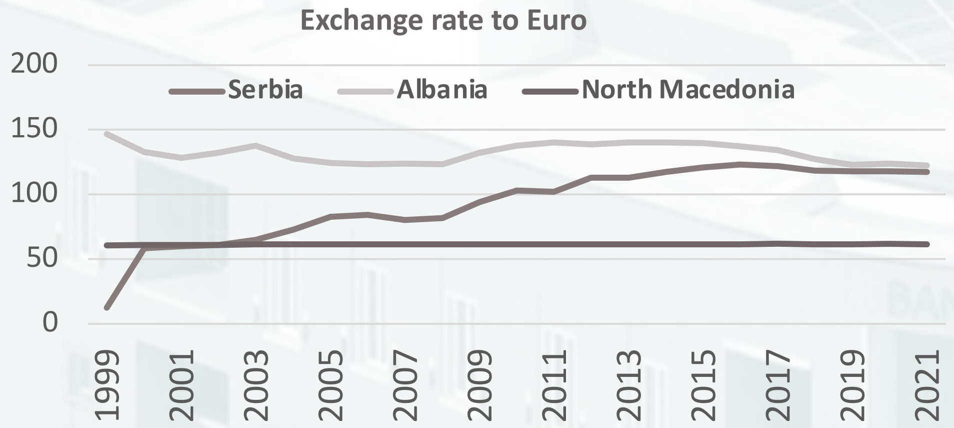
- External financing
- Relaxed lending standards
- Inappropriate risk management frameworks

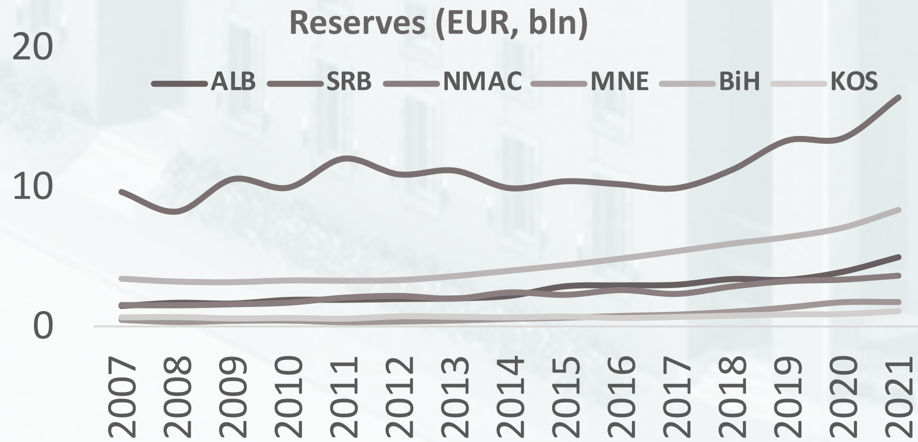
<u>The slow recovery after the GFC</u> was partly due to tight lending standards and low risk appetite, driven by:

- Tighter EU banking sector regulations
- A thorough revision of EU-banks business models'
- Wide scale EU bank deleveraging and de-risking

3.1 Asymmetric shocks: *Policy shocks*

Accommodative ECB monetary policy and its QE programs induced appreciation / deflationary pressures





Source: IMF, Eurostat

Exceedingly accommodative ECB monetary policy after the ESDC and the pandemic (especially the QE programs), resulted in ***appreciating pressures across the WB countries***

This appreciation caused both ***a loss of competitiveness*** for the WB countries and large ***deflationary pressures***

It was partly mitigated by a ***build up in reserves***, and also by an ***accommodative monetary policy*** in the WB countries.

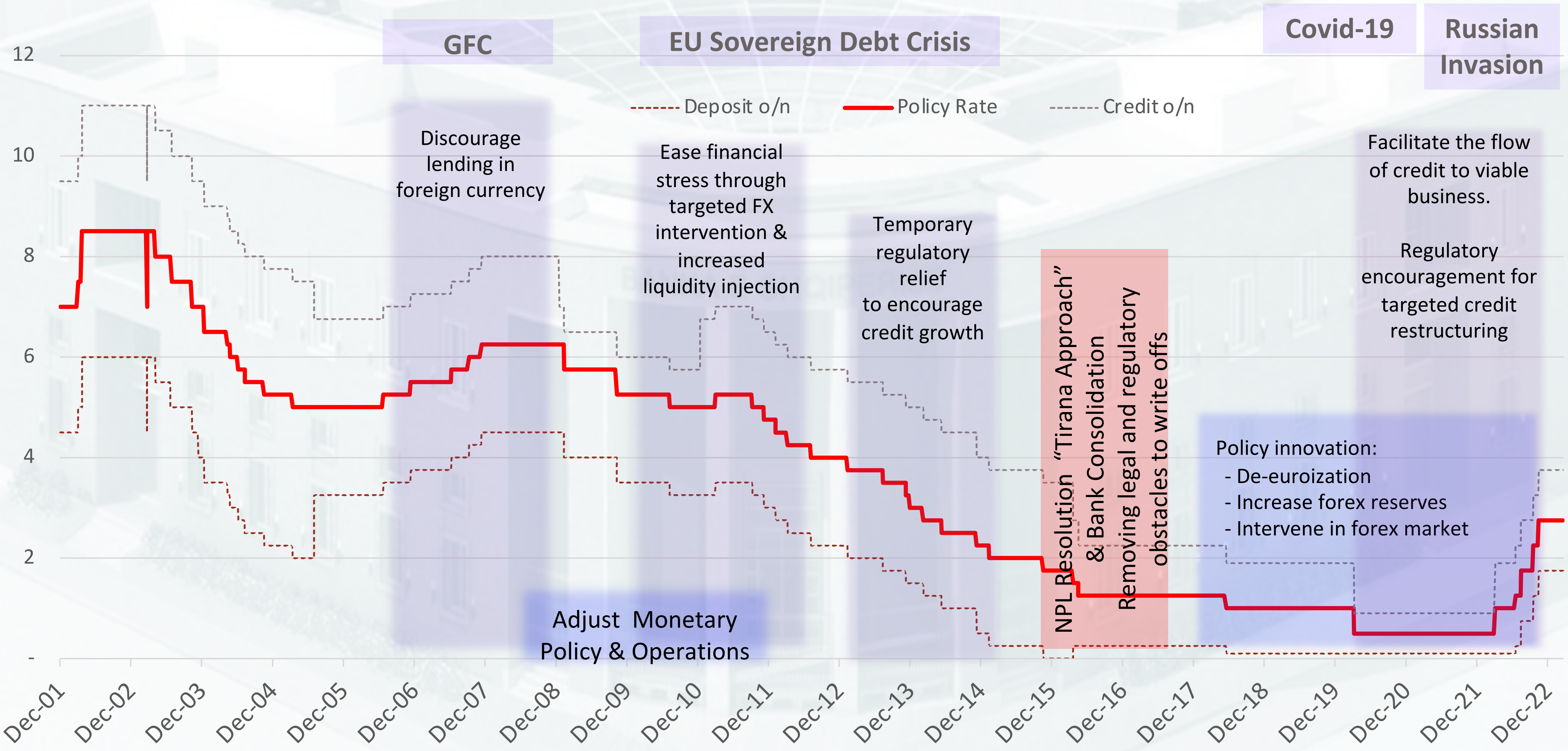
3.2 Policy response to shocks in Albania

Faced with a succession of foreign shocks, **the BoA responded in a comprehensive manner**, through a combination of monetary policy instruments, macroprudential tools, and financial sector reform.

Monetary policy tools	Macroprudential policies	Structural reforms
Adopt forward guidance as part of the standard monetary policy toolkit	Aligning our regulatory framework & supervision practices to the ESCB standards	Enhance the overall architecture: • Introduce the AFSG (MoF, BoA, AFSA, DIA) • Improve the functioning of AFSA & DIA
Adopt FX interventions as a non-conventional monetary policy instrument	Adopt a countercyclical framework of macroprudential policies	
Improve our liquidity management framework	Adopt a risk-based approach to the supervision of the banking sector	Improve credit environment through a comprehensive NPL resolution framework
Widen the base of collateral accepted in our liquidity injection operations	Tighten liquidity & capital requirements, and risk management practices	Introduce the Banking Resolution Law and establish the Bank Resolution Fund
Switch to unlimited liquidity injection operations (when needed)	Encourage early credit restructuring	Encourage the consolidation of the banking sector, resulting in a larger role of local players
Improve our FX reserve adequacy framework	Adopt a financial de-euroisation strategy	Improve the functioning of money markets (interbank, gov't securities, FX)
Improve our monetary policy communication and increase its transparency	Discourage unhedged FX lending	A comprehensive upgrade of our domestic payment systems

3.2 Policy response to shocks in Albania

Bank of Albania’s policy reaction to shocks was multidimensional in terms of instruments



4. The road ahead

- Our joint experience with the EU integration process revealed valuable lessons for all relevant parties:
  - EU
  - WB central banks
  - WB country authorities

- The road ahead should make use of these lessons

4. The road ahead: the EU

- The convergence challenges have forced EU to adopt a more flexible approach
  - Vienna 1 and Vienna 2 initiatives have helped mitigate the deleveraging process
  - In 2018, the EU Commission adopted a more transparent approach towards EU integration
  - The EU established WB Investment Framework, to deliver a Tailored Economic and Investment Plan

- The ECB has also increased its flexibility towards WB central banks:
  - **Participation of WB central banks in joint committees**, such as Supervision Boards, Banking Resolution
  - **Financial agreements**, such as use of currency swaps in case of emergencies

- Looking ahead, the EU should constantly monitor the process and periodically adjust its policies:
  - Adopt it to new economic and political realities
  - Develop instruments to mitigate shocks in the region and show more solidarity

4. The road ahead: Central Banks

- Central Banks have no primary role in growth-enhancing structural policies but:
  - **<u>They are vital</u>** in establishing stability-enhancing policies
  - **<u>They have a crucial role</u>** in the EU integration process
    - Facilitate financial integration with the EU, alongside real economy convergence
    - Equivalence of regulations, practices and laws, providing cohesion with the European System of Central Banks
    - Maintain a monetary environment characterized by stable prices and low exchange rate volatility

- Central banks should remain flexible and constantly evolve their policy toolkit to meet new challenges

- Central banks should not be overburdened with many objectives and a wide-range of policy instruments, they should stick to what they do best.

4. The road ahead: WB Country Authorities

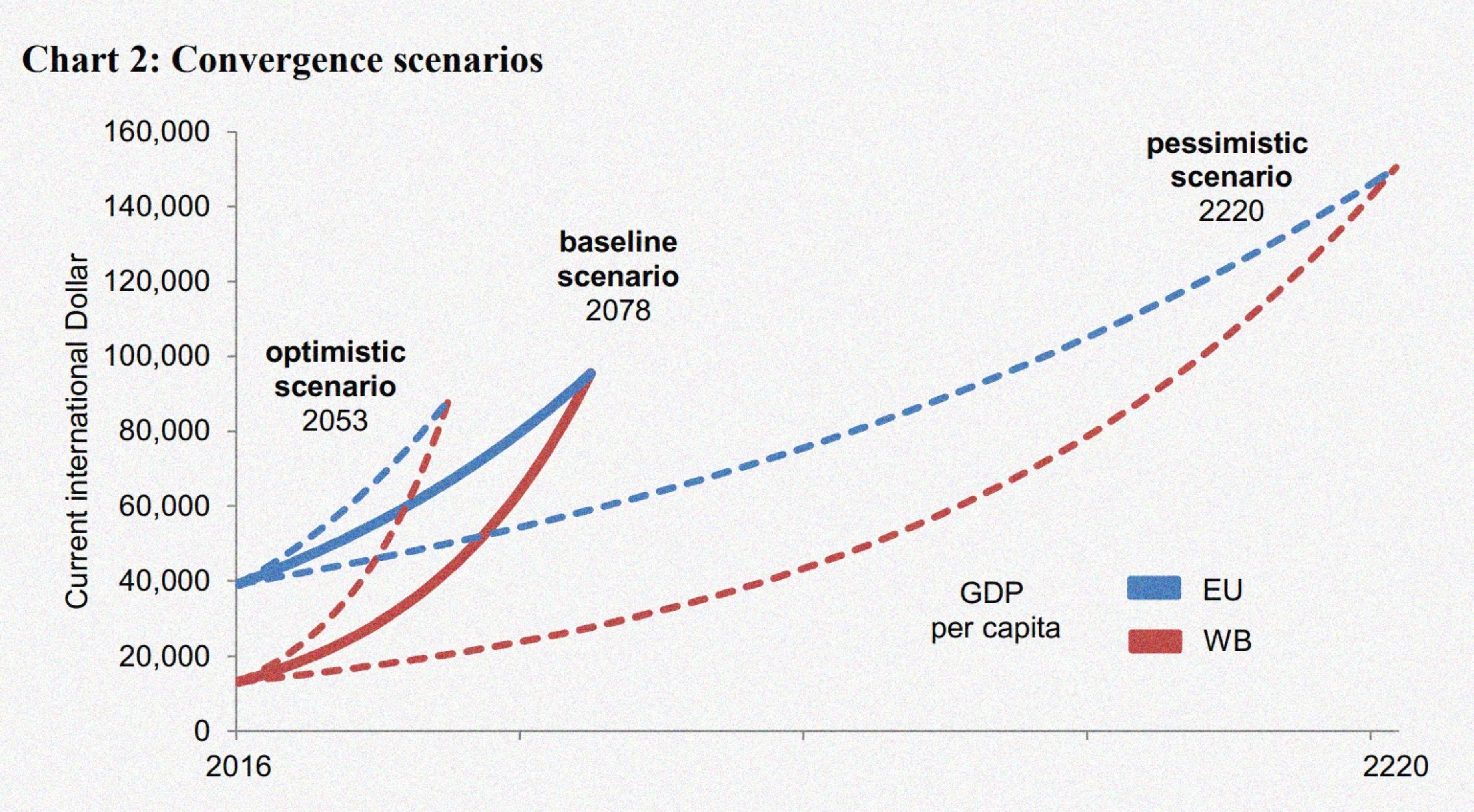
- The EU integration process is a useful tool to:
  - Foster structural reforms
  - Align policies and regulations
  - Upgrade domestic institutions
  - Improve business and investment climate

- However, the process is not without risks:
  - Reform stalling
  - Policy challenges

- **A realistic understanding of costs and benefits, as well as risks and rewards is needed!**

4. The road ahead: Convergence scenarios

The structural policy agenda is instrumental in accelerating the catch-up process



Source EBRD

Thank You!