Anita Angelovska Bezhoska: Speech - National Bank of the Republic of North Macedonia 8th Research Conference

Speech by Ms Anita Angelovska Bezhoska, Governor of the National Bank of the Republic of North Macedonia, at the National Bank of the Republic of North Macedonia 8th Research Conference, co-organised with the European Investment Bank, Skopje, 28 April 2022.

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Respectable Minister of Finance, Mr.Besimi,

Governors and central bank board members,

VP of European Investment Bank, Ms Pavlova

VP of European Bank of Reconstruction and Development, Mr.Bowman,

Alternate Executive Director of IMF, Mr Dresse,

Representatives of IMF, EIB, EBRD and BIS,

Representatives of the banking sector,

Representatives of academia,

Distinguished guests,

It is my great pleasure and honour to address you at the opening of the Conference co-organised with the EIB. This conference holds a special meaning for us. It marks three decades of monetary sovereignty, denoted by an independent central bank and stable national currency. It has been a long journey requiring a lot of efforts, knowledge and courage to withstand many turbulences. We have confronted many mountains at the very beginning of the transition in particular. However, as it is said "No matter how high a mountain you think has come in front of you- take small steps every day and you will eventually reach its summit". Indeed, continuous prudent steps have resulted in a long-lasting delivery of low and stable inflation and exchange rate, as a foundation for the overall macroeconomic stability.

Unfortunately, at this very moment we have once again faced new challenges, i.e. new mountains that underline the importance of policymakers' capacity to climb up the top.

In only two years, the world we knew has dramatically changed. The humankind has faced threats that seemed to be forgotten in the modern world, an unprecedented pandemic and a war in Europe, which are not only a human tragedy, but also supply shocks with significant economic costs that may profoundly reshape the world economy and geopolitical landscape. **This environment creates many challenges for the macroeconomic policies, as well.**

The pandemic was a shock of unprecedented nature causing global supply disruptions, supply demand mismatches, and exceptional patterns of economic behaviour. However, the policy response was of unprecedented nature and size, contributing to relatively swift and job-reach recovery. Thus, for example unlike GFC when it took seven years for the euro area GDP and almost twelve years for unemployment to return to its pre-crisis level, this time it took only one year to return to pre-crisis level and unemployment to hit record low. These developments are also relevant for some of the CESEE transition economies with strong trade and financial ties with the advanced Europe. This was a showcase of how a sizable and well-coordinated monetary and fiscal mix can mitigate the adverse effects of a large exogenous shock.

Unfortunately, while calibrating our exit strategies and reverting to a normal mode, another shock wave came pushing energy and food prices further up the curve, hence accelerating inflation while overshadowing growth recovery.

Thus, after a decade of **persistently low inflation and difficulties of central banks in reaching inflation targets, last year** this trend reversed and we have been witnessing a return of inflation across almost all economies. About half of the emerging economies have inflation higher than 7%, which is the highest share in the last two decades. In North Macedonia, as a highly open and import dependent economy, inflation has reached 8.8%. Although supply shocks tend to be temporary and usually limited to price changes of a limited number of consumption items, the recent data points that price shock may be more persistent and more broadly based than initially anticipated. For example, in emerging economies, more than half of the items of the consumption basket have high inflation, including services that tend to have more persistent effect. More persistent and broad-based price changes may lead to "backward-looking" inflationary expectations, as was the case before 1990, affecting the wage-setting process. In fact, the latest Consumer Survey of the EC indicates that inflation expectations in most of the CESEE economies have already picked up.

So, how temporary and how strong the effects can be?

According to the **latest IMF forecast**, the current crisis may result in higher global inflation by 3.6 p.p. with stronger effect in emerging economies, where it is estimated to average close to 9%. In a regional context, expectations go up to 8.0%.

On the other hand, the growth prospects are gloomier, with global growth forecast trimmed by 1.3 p.p., with similar downgrade for the CESEE region (1.7 p.p), where growth is revised down to 3.0% on average. The economic loss will not be contained during this year, as visible by downward revision for the next year, as well. **Overall, while current recession is not a central scenario, the risk thereof is not out of the window.**

Against this background, policymakers are faced with delicate trade-offs - **how to address the risk of stalled recovery/ recession, while curbing the rising inflation?**

Fiscal and monetary policy again are expected to play their role in mitigating social costs, although now in a more complex environment than during the pandemic, which calls for different division of labour. In a high–inflation environment, monetary and fiscal policy cannot work hand in hand to support demand, as they did when the pandemics emerged. Now central banks do not have leeway to focus on other objectives beyond their traditional remit. They have to remain focused on their mandate of medium-term price stability, which requires gradual normalization of monetary policy.

Short-term effects of the crisis have to be addressed by using fiscal policy tools, which given the tight fiscal space need to be well-targeted and time-bound. Another argument that supports the above is that despite normalization, monetary policy will remain accommodative as observed by historically low real policy rates. Overly expansionary fiscal policy may de-anchor inflation expectation and further fuel inflation.

So far, some of the central banks have "looked through" these supply side factors, while others, where labour markets have been tight and economy has been gaining steam or inflation expectations have risen, have already started the tightening cycle. The tightening of monetary policy in the advanced world may lead to headwinds for EMEs that may well have no choice but adjust their monetary policy stance. Not doing so risks capital outflows and currency depreciations, further fueling inflation. Emerging Europe already witnessed 300 million US$ outflow since the beginning of the war, though it is far smaller than in March 2020 when they amounted 1.7 billion US$.

While calibrating monetary policy, we also have to be mindful of the price effects of some structural forces such as green transition and globalization, which may put upward price pressures. In the past, globalisation enabled rapid trade integration of many countries, lifting up their growth potential and putting persistent downward pressure on inflation. **Now, with globalisation under threat, price pressures are upward.**

Overall, in an environment of rising inflation and limited policy space, blanket support should give way to more targeted and time bound policies, and even more importantly shift the focus back to structural and transformational policies, which are key for lifting the growth potential and building resilience. The latter is particularly relevant for the countries in the region that are faced with slow real convergence and stagnant growth potential.

The slower catching up of the region is not a new phenomenon as it came on the surface right after the global financial crisis. Most of the post transition real convergence (around 60%) occurred in the 5-year period preceding the GFC, against the backdrop of the remarkably growth-conducive global context, rising globalisation and trade integration, as well as favourable terms of financing. Afterwards the convergence slowed down, and it took twelve years since 2008 up to the pandemic to achieve the pace pertinent for the five years pre GFC period.

Now, with the global environment becoming highly uncertain, risk of deglobalisation and supply chains defragmentation becoming more certain, and tightening of the global financial conditions already in place, faster real convergence seems even more complex issue. In this vein, there are estimates that crisis has adversely affected growth potential of the CESEE region with average decline of 0.7 pp in 2020.

What are the main structural hurdles that prevent lifting of the growth potential and resilience?

Growth accounting framework reveals that in the last decade the slowdown was mostly through the total factor productivity, while the growth in the region became more reliant on capital accumulation. Given the wide capital stock gaps compared to the more advanced countries, the accumulation of capital is warranted, and preferable way to grow. Yet, the fact that the other sources of growth seem to be muted, gives ground for concerns. The contribution of labour is negligible, bringing to the fore the question on declining labour participation in the region, underpinned by the demographics and the intensive emigration of young and skilled workers. But, the marked slowdown in TFP, which is an indicator on how efficiently production factors are used, is worrisome.

There are many forces that can influence total factor productivity and they are all endogenously interlinked. The competiveness of the economy, the quality of human capital, quality of institutions, innovation and technological readiness are just some of them. Unfortunately, the region is not well positioned along those dimensions. The average ranks for quality of institutions and human capital, according to the global competitiveness index, stand at 63 and 53 out of 141 countries, which is still distant compared to more advanced countries. The recently published EBRD digitalisation index, on average for the region, is gravitating around 70, with a wide gap to be closed compared to the frontier of 100.

Is there any role for central banks in supporting the structural agenda?

Although this is obviously beyond the central banks' remit, still they can provide a support in some segments such as digitalization, which can unleash productivity revival or tackle climate risks - an issue that is becoming intensively proliferated among central banks. It is neither a coincidence nor an attempt for central banks to be more impressive and fancy. Climate risks can severely affect the capacity to grow, the prices dynamics, financial stability as well.

Let me conclude,

It is very challenging to deliver the goals and evolve when the top of one mountain is a bottom of another. However, we have to keep climbing with steps that will not only mean addressing the current burning issues, but structural hurdles as well. Macroeconomic policies can play a growth-supporting role, especially in the short-term, but cannot be a substitute to structural policies, which are key for increasing the resilience and lifting growth potential. In fact, many challenges that we face today are a result of neglect of structural policies in the past. It is not an easy task but to quote Jane Goodal **"What you do, makes a difference, and you have to decide what kind of difference you want to make".** And we as policymakers have to do what makes our societies more prosperous and resilient.

Thank you.