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Panel discussion

**Monetary policy challenges resulting from the rapid credit growth in the CEE**

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Rapid Credit Growth in Converging Economies.

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Ladies and Gentlemen,

In recent years we have witnessed a rapid growth of credit in CEE countries. Today, I would like to focus on globalisation as one of the main causes of such development. First, I will explain how globalisation contributed to recent credit growth in the CEE and then I will discuss what could be the possible consequences for the monetary policy of vanishing globalization “tail wind” in the nearest future.

To start with, let us define the term globalisation, as its meaning is so broad, that when it is referred to in a discussion, various people understand various things. One of the definitions of globalisation is provided by the International Monetary Fund<sup>1</sup>, where it is construed as “the growing interdependence (integration) of national economies, in particular as a result of the growing international trade and financial flows”. Moreover, an element of globalisation that is worth mentioning is the fast flow of information and knowledge, which is the driving force behind globalisation processes. One should keep in mind that globalisation is not a completely new phenomenon. In view of the existence of political barriers to international trade, the flow of capital and goods was equally as possible one hundred years ago as it is today. It goes without saying, however, that as a result of the rapid development of technology, especially in the ICT area, which drastically lowered the cost of the said exchange, the international

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<sup>1</sup> See IMF (2000)

integration of trade, investment, financial and other services is now more advanced than it has ever been before.

In recent years globalization “tail wind”, mainly through increasing competition, productivity and growing imports from low-cost countries, helped to reduce inflation in CEE countries. HICP inflation in the region<sup>2</sup> fell from average 7.7 percent in the years 1997-2000 to 3.8 in 2001-2006. It led to a prolonged period of very low nominal and real interest rates. Nominal interest rates (average for CEE countries with flexible exchange rate regimes) have fallen from 8.8 percent during 2002-2005 to 5.4 during 2006-2007. Real rates decreased from 3.0 to 1.7 in the same period. This in turn helped to accelerate credit growth and fuelled asset bubbles. The amount of loans granted to households increased 3.5 times since 2004 and almost 10 times since 2000. Low deposit rates and economic upturn in CEE after EU accession encouraged both financial institutions and individuals to move toward more risky forms of investment. As a result, real estate prices soared after 2004 and equities listed on stock exchanges reached historical highs. Since 2003 major stock exchange indexes in CEE increased on average by almost 300 percent. While part of this asset price and credit growth may be explained by structural factors often referred to as “convergence”, the observed rates of growth are clearly unsustainable and they contribute to economic imbalances.

With the benefit of the hindsight one could argue that monetary policy in the last few years did not properly take into account the possibility that prolonged period of historically low interest rates may contribute to asset bubbles and hence contribute to greater inflation volatility in the future. As argued by Rogoff (2006) when faced with a tail wind monetary authorities in both developed and developing world should have temporarily lowered the inflation target rather than reduce interest rates too much for too long. But there is another issue. It seems that globalisation tail wind is reversing these days and that in the coming few years central banks can face “globalisation headwind” amid rising food and energy prices.

**1. Agflation**, is the rise of inflation due to increase of food prices. In recent months we have witnessed a significant increase of food prices, grain and oilseeds being the leaders. Prices of food products on international markets has risen by almost 40 per cent within last two years and prices of grain and oil seeds has almost doubled within this period. Many forecasters suggest that this trend will not end in the nearest future. There are several explanations of such situation. Firstly, rising oil prices increase demand for

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<sup>2</sup> Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovenia, Slovakia.

alternative sources of energy, biofuels being high on the agenda in many regions. In effect industrial demand for food commodities will further rise. By the way, it is worth to mention what may be the ecological consequences of growing biofuels production. Spiegel online on 26<sup>th</sup> September 2007 described a research led by the Nobel-price winning chemist Paul Crutzen which had found that biofuels emit even 70 percent more greenhouse gases than fossil fuels. In effect, global warming may accelerate and lead to further increase in frequency of disasters such as floods, droughts, and unexpected weather changes that may have negative effects on crops. Secondly, food prices will be lifted up by an increasing demand for agriculture products in the emerging markets, especially in Asia, as the catching-up process progresses. It is worth keeping in mind that the share of food in the CPI basket is some 10 pp. higher in CEE countries than in the eurozone, so agflation, if it materializes, will lead to inflation divergence.

2. **Other commodities prices.** Demand for commodities, just as for agricultural products, has substantially risen in recent years. The “problem” lies again in the emerging markets. Fast growing economies create still growing demand for all sorts of commodities, especially metals and fuels (for example: oil consumption in China has doubled within last 10 years). As the result, prices of metals and energy commodities has doubled since the end of 2004. Although prices of these products do not affect consumer inflation directly, in the medium term will contribute to further increase of inflation volatility.

The tail wind of globalization will probably return in the medium run, but structural adjustments, which may take several years, must be completed first. Rising white collar and industrial wages in emerging markets will attract more and more people to the labour market and will consequently lead to adjustments in education systems in those countries. Labour force “great doubling”<sup>3</sup>, together with significant increase of the quality of human capital due to better education system will contribute to further increase of offshoring directed to still cheaper emerging markets. Offshoring, as a strategy of increasing competitiveness, is becoming more and more common and includes not only the manufacturing of products but also — increasingly — services. Numerous analyses show that the process of offshoring is bound to grow and increasingly affect services<sup>4</sup>. For example, McKinsey Global Institute estimated that in 2008 ca. 160 million jobs in services, i.e. 11% of the global employment in

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<sup>3</sup> See Freeman (2005)

<sup>4</sup> Rybinski (2007)

services estimated at 1.46 billion, may theoretically be performed at a distance from the customer.

It is hard to forecast, however, what the global consequences of such situation will be. On the one hand, offshoring lowers operational costs of enterprises and thus optimal mark-up pricing allows to reduce prices. On the other hand, rising labour demand will lead to higher wages and depending on productivity growth may also lead to higher unit labour costs. Higher wages also imply higher consumption and a further rise of demand for commodities in emerging markets.

As the tail wind of globalization is reversing these days, the most difficult challenge which CEE countries will have to face with is to keep fast real growth and, at the same time, to manage nominal convergence – indispensable condition of EMU graduation. There are some issues which will make this task even more complicated:

1. **Migration.** One of the major obstacles is the massive emigration of workforce observed in the New Member States after joining the European Union. In Poland and the Baltic states some 4 to even more than 7 percent of a labour force attracted by higher wages, job availability and better living conditions migrated so far to the EU-15. This has led to severe tensions in many industries pushing wages and unit labour costs up. High corporate profits have provided a cushion yet, but, if this situation continues, many companies will be forced to raise prices to remain profitable.
2. **Rising unit labour costs.** Growing tension on the labour market is present in all CEE countries, but Baltic and Balkan States seem to be the most threatened by rising labour costs. Annual average dynamics of unit labour costs in the second quarter of 2007 in CEE accounted to 8 per cent and in the group of Baltic and Balkan states the figure was over two times higher. This shows that sooner or later (rather sooner) enterprises will stop cutting their profit margins and will be forced to pass growing operational costs on consumers.
3. **Productivity growth.** We live in a global knowledge economy, which is driven by innovation – technological, business-process or customer related. The crucial factor to succeed in the global knowledge economy is the country's ability to develop intellectual capital. Only those who understand the importance of innovations for growth will thrive and prosper in the coming decades. Unfortunately, CEE region lags badly behind the leaders in terms of its current and future ability to generate

innovation. One of indicators measuring current ability to innovate is the number of researchers. In the mid-1990s CEE-4 (the Czech Republic, Hungary, Poland and Slovakia) and NIEs regions had similar number of researchers per million people, while two years ago NIEs had almost twice as many persons employed in R&D per million people in comparison with CEE-4. Future knowledge potential of particular country or region can be measured by tertiary enrolment ratio. Tertiary enrolment ratio in the CEE-4 countries improved to 50 percent in 2004, but still remains well below 62 percent in the EU-15 and 82 percent in the United States.. Because of a relatively small population and a number of structural deficiencies it is very unlikely, that increase in the number of students in CEE-4 that have occurred in recent decade will translate into higher innovation potential in the coming years, unless a dramatic change in policies in CEE-4 is made. This is also confirmed by a dramatically low number of patents registered in the CEE countries and extremely low number of scientific publications. As the ability to generate great ideas in the CEE region is limited, it seems that in the transition period the most important modernization channel in the region was through foreign direct investments. Indeed CEE became a very large recipient of FDI, with FDI stock to GDP ratio topping 40 percent in CEE-4 region. Only NIEs economies managed to attract higher FDI stock in relation to GDP and enjoy higher FDI annual inflows. However, in the global knowledge economy it is important to attract foreign direct investments to sectors that can become globally competitive, in particular to these sectors that export high-technology, i.e. high value added goods or services. While CEE-4 significantly improved the structure of exports, the high-tech goods account for only 12 percent of manufactured exports, which is the world worst result, lagging even behind Latin American countries. NIEs are world leaders and China is about to take over the second post from the United States. Above data suggests that in the long run low ability to generate innovation combined with low value added FDI may harm the CEE ability to improve productivity.

Summing up, with the inflation headwind expected in the coming few years CEE central banks will face a possibly steep sacrifice ratio when controlling inflation. Keeping inflation at the target consistent with EMU accession may require sizeable reduction of the output gap, which in turn may make fiscal targets difficult to achieve.

Tail wind of globalization appears to be fading in the coming few years and if agflation or surge in other commodity prices materializes, joining EMU may become “mission

impossible” for many CEE countries in the next few years. The window of opportunity created by global inflation “tail wind” might have closed in 2007.

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