Mugur Isărescu: Hard landing unlikely for Romania

Interview with Dr Mugur Isărescu, Governor of the National Bank of Romania, by Mediafax news agency, Bucharest, 8 September 2008.

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Mr. Governor, foreign analysts have placed Romania along with four other states – Lithuania, Latvia, Estonia and Bulgaria – in a group of countries heading to a hard landing. In fact the economies of Estonia and Latvia have contracted sharply, with growth plunging from levels of around 10 percent into negative territory; inflation has reached two-digit levels and the external deficit exceeded 15 percent of gross domestic product. Is it possible for Romania to witness similar negative growth dynamics? Is it fair to include Romania in that group?

Reading what those foreign analysts said, I have hardly found a solid rationale that would justify Romania's being placed within the hard-landing risk zone. On the contrary.

Turning now to comments, I will underline that there are some similarities among the countries in this group: GDP per capita is below the EU average, they all have registered high growth rates in the catching-up process. However, there are also fundamental differences, among which the most important in my view is the monetary policy mechanism. Three of the four countries mentioned in the group have currency boards in place, and the fourth, i.e. Latvia, has a mechanism close to a currency board. Of course, currency board has its clear benefits. Let us remember that, for example, in Bulgaria the inflation rate had topped 1,000 percent and the economy was in shambles. The introduction of the currency board was the solution which, at unavoidable social costs, brought the Bulgarian economy afloat, with inflation falling steeply and staying close to EU levels for a good couple of years. But the currency board has its limits and constraints. The BNR has constantly opposed the adoption of such a system by Romania given these limits and constraints. Actually, a country adopting the currency board is deprived of monetary policy and thus the central bank becomes a sort of an institute for statistics. Instead of a two-pedal vehicle – monetary and fiscal policies – the economy of currency board countries has only one pedal left, namely the fiscal policy. Assuming the risk of an extended comment, let us look at what happened in the four countries and what happened in Romania in the past few years in a rather unusual international context, with the euro appreciating simultaneously with the increases in farming products and energy prices.

The appreciation of the euro triggered a slide of output competitiveness in the countries having their exchange rate pegged to the euro and the rises in global prices boosted domestic inflation. Currency board countries could change neither the exchange rate, nor the interest rates which are linked to euro area levels, currently standing at 4.25 percent a year. Therefore, with inflation running at 16-20 percent in the Baltic States, interest rates became strongly negative in real terms and the monetary policy procyclical, boosting consumption, while the fixed exchange rate has discouraged production. Basically, the main weakness of the currency board, namely the inability to respond to exogenous adverse factors, pushed the economies of those countries towards a hard landing.

Let's look now at the picture in Romania. Our exchange rate regime, featuring a flexible exchange rate in a managed floating system, allowed the market to correct the overappreciation the leu had registered at a certain point via its own mechanisms, and the BNR was able to raise interest rates – which it did seven times already over the past 10 months – in order to permanently keep them in real-positive territory and curb inflation which had been triggered by the same external factors that affected the countries you have mentioned before. The BNR has even moved forward in order to slow down consumption and maintain a healthy portfolio for commercial banks via the recent prudential measures regarding loans to households. All these have significantly contained the risk of a hard landing for the Romanian economy, even if such a risk still lingers as long as the gap between the current account deficit and its financing via FDI remains significant.

Nevertheless, the foreign analysts that included Romania in the group of the five countries exposed to a hard landing had substantiated their opinion. Are they completely wrong?

Let us make an assessment. One of the reasons they brought forward was that Romania's fiscal policy is procyclical. Well, although we are in an election year, we have reasons to believe that the 2008 budget deficit will stay below 3 percent. Moreover, the central bank has additionally tightened its monetary policy in order to offset the insufficient restrictiveness of the fiscal policy.

Another reason is that income policy is much too expansionary, and this too is our concern here at the BNR. We have sent repeated warnings in this respect, the more so as a possible offsetting via further tightening of the monetary policy could not only prove ineffective, but also counterproductive, both leading to a deterioration of external competitiveness. Re-establishing a long-term balance between income growth and productivity dynamics is therefore a must.

Finally, I saw in some papers that Romania would be downgraded because of its external liquidity position. This indicator is computed as a ratio between the country's international reserves and its overall foreign debt, both public and private, in the short-run. We have a sub-par ratio in Romania, as short-term external debt is higher than reserves. I believe this is also an overstatement, as Romania's international reserves are close to the upper limit of the optimal level if we take into account the other indicators, such as the ratio between reserves and imports. The short-term external debt is high indeed, but the bulk of it belongs to the private sector. And out of this, loans taken by foreign-based banks operating in Romania from their parent undertakings abroad account for the largest share. We have started to address this issue by taking measures aimed at discouraging foreign currency-denominated loans. If that risk materialised and parent banks diminished their flows to Romania, the effect would be rather beneficial as it would remove the base for an unsustainable expansion of foreign currency-denominated credit which has been a headache for so many years.

Therefore, I do not consider these arguments that solid to place Romania in a group of countries with high likelihood of witnessing hard landing.

Do you think, therefore, that high economic growth in Romania will go on?

I believe that Romania will see further economic growth in the coming years. A growth much closer to the potential which our experts had estimated at around 6 percent annually. It is true that, with weakening economic activity worldwide, especially in the EU which is our main trade partner, economic growth might be a bit slower than 6 percent. No doubt that economic growth will be affected by several factors next year, placing it over or below 6 percent: the oil price, the farming year, heightened efforts to develop the infrastructure and also to create conditions to boost labour productivity, the level of foreign investments, and so on. In any case, a 6 percent annual economic growth in the present context is a remarkable achievement. That would not prevent some analysts from saying that, if GDP growth slows to 6 from 9 percent, the growth rate plunged by 33 percent.

An 8-9 percent growth means overheating? What is your opinion?

I have never ventured to say that one figure alone would mean the economy is overheated. I usually present things in a more nuanced manner, just like they are in reality. What does overheating actually mean? A development that substantially exceeds the growth potential, leading to an overheating of output factors, especially to a chronic lack of labour force and a fast increase of wages and prices. For this year, I believe we need a sectoral approach. On the one hand, we have a significant rise in farming output due mainly to natural factors. And there is no overheating there. On the contrary, prices of most agricultural products are falling and production factors – especially land, but also labour force – are obviously under-exploited. Romania's great farming potential has yet to be turned to account. On the other hand, in construction, another major contributor to this year's growth, there are visible signs of overheating: scarce labour force, substantial increases of prices for building materials, higher wages, etc. Of course, a wise policy should stimulate only the sectors where the potential is not fully exploited (such as agriculture) or where we have bottlenecks, as it is the case of road infrastructure in Romania.

However, there are numerous opinions according to which rating agencies could downgrade Romania. Which would be the main risk factors that could lead to a downgrade?

So far, rating agencies have only changed the outlook, not the rating. To answer your question – although I do not believe that Romania will be downgraded to below "investment grade" – the main risk factor remains the current account deficit. We have implemented tight monetary policies to tackle this issue. I believe that at the end of this year we will see a containment of this indicator to its 2007 figure of 14 percent of GDP as compared to some analysts' expectations of 15-16 percent. This is a positive thing for a start but we should not stop here. Romania needs policies that would allow a gradual and predictable reduction of the current account deficit to levels almost entirely covered by direct capital investments to regain confidence of the rating agencies and ensure an improvement of external creditworthiness. We will be thus forced to implement a gradual correction of this deficit, even by a few percentage points in the next two to three years, and it is desirable that this happens in the context of sustainable economic growth, close to the potential, while consolidating disinflation which will resume this autumn after a few quarters of considerable efforts. In this respect, the BNR opinion has been repeatedly expressed in public, namely that such a correction can only be made via a balanced mix of monetary, fiscal and income policies, coupled with faster structural reforms that would lead to higher productivity.

What would be the effects of a downgrade for Romania?

Let me stress this again, I do not believe in a downgrade. As I have already mentioned, we may see a change in the outlook. If there is a downgrade, its consequences would be rather serious. It would primarily be reflected by the marked increase in external financing costs, but also by deterring FDIs, which would limit the country's rapid growth potential.

Why do you think rating agencies are more cautious about Romania than about other countries?

It may be because of an insufficient clarity regarding the real economic and financial situation of Romania, which may derive also from the inconsistent signals that sometimes come from inside the country.

Thank you very much, Mr. Governor.