Mugur Isărescu: Issues related to real convergence on the path to euro adoption

Presentation by Mr Mugur Isărescu, Governor of the National Bank of Romania, on the occasion of the session organised by the Romanian Academy on "The Euro Adoption Strategy and the International Financial Crisis", Bucharest, 2 October 2008.

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The Romanian authorities set as a strategic economic policy objective the fulfilment of all the requirements that would allow the adoption of the euro as the national currency in 2014. Although this is an ambitious objective, it can be achieved provided that a coherent economic policy mix is adopted and maintained to support both nominal and real convergence with the euro area countries.

Mention should be made that, in order to join the euro area, only the nominal convergence criteria need to be considered: a stable exchange rate, subdued inflation, interest rates close to those applied by euro area countries, moderate budget deficit and public debt. Nevertheless, the maintenance of the convergence of nominal indicators in the long run and even the turning to good account of all the advantages derived from being part of a well-functioning monetary system compel us to equally consider the accomplishment of real convergence between the European developed economies and the Romanian economy. In this context, Romania's adoption of the single currency before achieving a minimum level of real economic convergence would be risky and counterproductive. We have to make sure that when achieving the nominal criteria a substantial progress in real convergence will have been achieved as well.

Thus, in my presentation today I thought that, by giving an analysis of the Romanian economy's path to the adoption of the European single currency, it is adequate to focus not only on nominal convergence, a topic which I have repeatedly approached, but also on several issues pertaining to real economic convergence. Or, this means, in a plain language, to put in place the conditions necessary for a rapid, sound and sustainable economic growth. The large disparities between the performance of the Romanian economy and that of European Union countries compel us to do that.

In this context, allow me to approach a topic less debated during public meetings in our country, but which is deeply linked to the capacity of the Romanian economy to maintain a rapid and sustainable growth. It is all about the general problems relative to structural reforms and, in particular, about labour market flexibility, the imperative need for this to come into line with the most modern practices applied in successful countries, by taking into account both the realities of the Romanian economy, and the requirements of competition on an increasingly demanding international market.

At first glance, there are few connections between the changeover to the euro and labour market flexibility. In fact, the connection is strong, even essential, I would say.

Before proceeding to a more in-depth analysis of the topic, allow me to clarify an issue that was subject to previous public debate. The National Bank of Romania has nothing against wage hikes. Quite the opposite, we might say. The Romanian economy could only benefit from an increasingly fast rise in wages, in order to enjoy a higher living standard, surmount the historical disparities that separate us from the Western economies and put a stop to labour force migration. Nonetheless, we must analyse with a clear mind and assert bluntly that a mismatch between pay rises and labour productivity gains is unsustainable. Wage hikes in excess of labour productivity are not likely to bring about a higher living standard, but on the contrary, they may lead to a lower living standard, given that, sooner or later, the disparity between the two fundamental indicators will entail a fast-paced rise in prices, the weakening of domestic currency, external indebtedness. All this has a negative influence on investment and delays the achievement of real convergence of the economy rather than speed it up.

Over the past few years, annual productivity gains came in at impressive 10% and beyond each year. Multiple factors stood behind this performance, such as the initial low level, the significant decline – even if not always illustrated by statistical indicators – in the population working in agriculture and, highly important, the strong increase in investment. However, this increase was exceeded by far by the wage hikes, which explains the sizeable widening of the external deficit, as well as the increasing inflationary pressures over the past year and a half. So, we embark upon this path, carrying a serious burden on our shoulders. I wonder what will happen the moment the increase in labour productivity slows down. Such a trend is closely connected to economic rigidities, the infrastructure-related issues, the slowdown in economic restructuring. In view of all these issues, the NBR does not embrace the idea of slowing down wage increases, but rather it advocates the creation of conditions likely to render this hike sustainable and maintain its actual nature. After all, from a nominal point of view, there is no limit to increasing wages. However, the market will admit only pay rises matched by labour productivity gains. The rest fuels inflation and the depreciation of domestic currency, taking the real level of wage rises to where it is matched by output and labour productivity.

Next, I would like to make reference to the factors that establish the direct connection between the NBR's legal tasks concerning wage increases, on the one hand, and the rise in labour productivity, on the other. In this vein, I must specify that, once Romania joined the European Union and the National Bank of Romania became a member of the European System of Central Banks, we are not only entitled, but also bound to present our viewpoint where we see that fundamental equilibria of the economy may be jeopardised by a particular development.

Hence, I will refer to the NBR's objective to ensure and maintain price stability and bring inflation rate down to a level compatible with its capacity as a member of the Eurosystem. Generally, a lower inflation rate is associated with a slower economic growth and even with recession. However, this phenomenon occurs only when there is a contradiction in the economic policy mix and when subdued inflation is not the primary objective of other policies, particularly fiscal and income policies. When the policy mix is balanced, inflation rate may be curbed while maintaining a sustained growth pace. Behind this development stand mainly foreign direct investment inflows which enhance the productive capacity of the economy and ensure the sustainable financing of a relatively high external deficit. In Romania's case, the experts working with the central bank as well as the independent analysts estimated that the national economy may further rise at a fast clip amid alleviating inflationary pressures, even in the context of a current account deficit of 8-10% of GDP. Nevertheless, in order for capital inflows to continue, Romania's economy must stay attractive. This attractiveness may no longer be objectively related to low unit labour cost or disproportionate tax facilities which would not comply with EU norms. Therefore, an investor-friendly environment should be the result of a different set of characteristics such as increased flexibility in the fiscal regime and in the labour market. Thus, the NBR's primary objective to ensure and maintain price stability is closely linked to the policy mix pursued by the Romanian authorities.

Another nominal objective which is essential for joining the euro area is exchange rate stability. In recent years, the improved performance of the Romanian economy enabled the significant alleviation of exchange rate fluctuation as compared with the situation in the last decade. In fact, the foreign exchange regime adopted by the Romanian authorities, namely a flexible exchange rate requiring far lesser interventions in the forex market by the central bank, bolstered the national economy. Even the over-appreciation episode in early 2007, generated by massive capital inflows following Romania's accession to the EU, was corrected via autonomous forex market movements. We may state that, at present, there are no significant pressure-inducing factors in relation to the exchange rate in terms of appreciation or depreciation, despite the temporary two way movements caused by global financial market turmoil.

However, the foreign exchange market has come into balance in the context of a policy mix featuring a restrictive monetary policy, with high interest rates, an insufficiently tight fiscal policy, subject to further pressures to increase public spending, concurrently with the drop in incomes, whereas pay rises have been in excess of productivity gains for a long time. This policy mix is unsustainable. One could hardly speak about long-run forex market equilibrium, even though in the nearer term, high interest rates may offset the effects of other policies. Nonetheless, it is clear that exchange rate stability in the context of worsening competitiveness of the Romanian products, following the increase in wages faster than that in productivity, leads inevitably to widening trade deficit and ultimately to exchange rate depreciation. Should this occur, I would not be surprised to hear voices blaming the central bank for this outcome, without trying to identify the actual, deep reasons behind the unfavourable developments.

Therefore, both subdued inflation and exchange rate stability are strongly related to the coherence of the policy mix adopted by the authorities. In particular, the run-up to elections laid the groundwork for making empty promises and even for adopting pieces of legislation that are likely to have a significant impact on macroeconomic equilibria. In this case, the NBR's task is to identify major risks arising from the implementation of ill-designed policies.

Unfortunately, credibility is hard to gain, but easy to lose. Losing credibility can have more severe effects than, let us say, the temporary government deficit widening.

The world economy is facing tremendous difficulties. I express my confidence that, the coordinated and appropriate policies of the most developed international economies will help prevent a crisis similar in size to that of 1929-1933. It is beyond any shadow of a doubt that this period will have a decisive impact on the world economic model.

During such hard times worldwide, it is necessary, now more than ever, that the Romanian authorities should exert caution and wisdom as concerns both public spending and specific promises. The run-up to elections is usually a period when hard to keep promises are easily made. At present, however, despite the most difficult international economic conditions in the post-war period, the pre-election public promises seem far more unrealistic.

I would like to reiterate the fact that the NBR policies focus on the euro adoption in 2014. In the medium run, we envisage not only the resumption of disinflation and bringing price hikes in line with the European standards, but also the alleviation of imbalances, especially the gradual narrowing of external deficit, in order to render disinflation sustainable.

In terms of monetary policy, it is crucial to foster savings with a view to narrowing the current gap in relation to investment. The increased contribution of the domestic component, amid the rise in saving ratio, can ensure the same high investment rate. In fact, the increase in interest rates, which is part of the current monetary policy stance, was aimed at fostering savings. The results are visible, even though – for statistical reasons – the NBR calculations appear to give a different picture. In order to avoid possible confusions, allow me to present several technical details.

The data released indicate a faster dynamics of demand deposits compared to time deposits, apparently hinting at the emergence of additional inflationary pressures. We are dealing in fact with two developments related to statistical evidence rather than real economic substance. One such development is the transfer, since 2007, of forex-denominated demand deposits from "quasi-money", which is part of M2, into M1 (narrow money). This is merely a matter of compliance with EU definitions. The economic substance has not changed: the Romanians do not resort to foreign currency accounts for current transactions, but rather as a means of saving.

Another development weighs heavier and it is also manifest in the case of forex-denominated current accounts, while being extremely significant from a quantitative perspective for RON-denominated ones. Since deposit accounts are subject to income tax, while current accounts are not, banks have developed a way to attract customers: current accounts whose yields are higher than deposit rates. This led to massive portfolio shifts to the detriment of traditional deposits, as households placed their savings in the so-called current accounts, or even card accounts, which are highly remunerated conditional upon maintaining a balance higher than a certain floor.

Central bank experts have adjusted the figures based on the assumption that actual demand accounts should see a growth similar to that of currency in circulation, as it was the case in previous years. Hence, it would appear that quasi-money rose over 80% December 2004 through August 2008 versus only 40% as indicated by statistical data. In other words, both household and corporate savings in domestic currency expanded at a pace much faster than that of time deposits. These statistics led the media to comment on a would-be stalemate in RON-denominated savings. The NBR specialists will make sure these developments are explained in further detail. This is how a fiscal policy slippage entails both a contraction in budget revenues and potential errors in assessing monetary developments.

Given the heightened turbulences on the international financial markets in the last few weeks and the fact that the NBR is vigilantly monitoring these developments, I believe we should refer to their potential impact on the domestic financial system and on the Romanian economy as a whole. The Romanian banking sector is still affected mainly by increased external financing costs. The limited impact is due to domestic financial environment characteristics, as well as to the prudential monetary policy and financial stability strengthening measures adopted by the central bank over the years. Let me highlight the most important of these measures.

First and foremost, credit institutions in Romania do not have exposures to subprime instruments, which lie at the root of the turmoil. This is particularly due to the profitability given by wide interest rate margins on the domestic market as well as to the fast-paced increase in lending via traditional banking products.

Secondly, the overwhelming majority of banks operating in Romania, including those with foreign capital, are legal entities subject to NBR licensing, regulation and prudential supervision. Similarly to foreign bank branches having their main office in other EU Member States, these banks abide by the Basel II prudential and capital adequacy standards.

Thirdly, some regulations issued by the National Bank of Romania have often proved more restrictive than the Basel II standards. More specifically, initial capital requirements for licensing a credit institution in Romania are almost twice as much as the minimum level laid down in EU regulations. Moreover, it is worth mentioning that the NBR representatives are part of the competent EU structures involved in the review and improvement of EU regulations governing the financial system architecture.

Last but not least, the minimum reserve requirement ratios are still high at 20% on RON-denominated liabilities with maturities of up to 2 years and 40% on foreign currency-denominated liabilities. In addition to their contribution to curbing credit expansion, reserve requirements also play a prudential role in credit institutions maintaining an adequate liquidity level.

Finally, let me point out the measures recently taken by the central bank with a view to ensuring sustainable credit growth in the longer-run. These measures are all the more useful amid the persistent turbulences on global financial markets. As a matter of fact, liquidity in the credit institutions sector in Romania – albeit relatively on the wane compared to previous years – is at a comfortable level to guarantee smooth market functioning, while the NBR has the necessary tools and mechanisms available to ensure liquidity in line with the applicable European norms.

All of the above are an indication that the domestic banking system runs a relatively limited risk of contagion amid the persistent turmoil on world financial markets. However, adverse effects may become manifest in Romania as well, among which: (i) more pronounced exchange rate volatility, following the trend seen by other countries in the region, given the increased risk aversion of investors on emerging markets, (ii) still rising costs of external financing and a decline in its volume, (iii) the likely moderation in the volume of autonomous capital inflows and the possible early repatriation of capital gains, (iv) potentially flagging demand for Romanian exports amid downward growth prospects in the other EU Member States.

The National Bank of Romania will continue to carry out its mandate with utmost vigilance as regards both price stability and safeguarding financial stability.

Allow me now to conclude by reiterating that the objective of joining the euro area in 2014 is within reach. By pursuing appropriate policies, the authorities could also meet the objective of rapidly raising the standards of living. However, breaking the fundamental equilibria through inadequate measures does not entail more welfare. On the contrary, it may put both real and nominal economic convergence in jeopardy. The strategic objective of euro adoption in 2014 is equally at risk.