Mugur Isărescu: The regional finance and investment for South East Europe

Keynote address by Mr Mugur Isărescu, Governor of the National Bank of Romania, at the Euromoney Regional Finance and Investment Conference for South East Europe, Bucharest, 12 June 2014.

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Prime Minister,

Ladies and gentlemen,

It is an honour for me to be invited to speak in front of such a distinguished audience. I am very glad that, after three years "off", Euromoney Conferences is re-launching the event in Romania. Time has come for Bucharest to host this important event, held for several years in Dubrovnik.

The joy of giving the keynote address at this conference is bigger as I had the opportunity to read the first issues of Euromoney magazine while being a young research fellow at the World Economy Institute in the early '70s. For years it was one of my favourite magazines. Back in 1978, I also had the opportunity to visit the editorial offices in London.

I could not help but notice that you have chosen a generous theme: ***"The Regional Finance and Investment for South East Europe"*** and you have set yourselves to approach themes that I am particularly interested in, like: pro-growth strategies in an age of austerity; what more can policy-makers do?; how will governments incentivise overseas investors?; how can the region increase EU fund absorption rates? I wish you fruitful discussions and I am looking forward to seeing what answers you might find to address the issues highlighted in the panels of this conference.

As the focus of the conference is on economic growth and development in Romania and the wider South-East Europe region, allow me to elaborate on this topic.

I will approach the subject from the perspective of a central banker. Let me start by saying that sustainable economic growth of both Romania and the region relies mainly on economic policy consistency. The global economic and financial crisis has proved yet again that there is no valid substitute for consistent economic policies. The correction of economic policy errors is, everywhere and always, painful and, while difficult to comprehend by the public at large, it is absolutely necessary.

The case of Romania is highly illustrative in this respect. Large macroeconomic imbalances had been steadily accumulating during the boom years, as a result of sizeable foreign capital inflows and credit expansion, the impact of which was augmented by a pro-cyclical stance of fiscal policy, especially in the last two years before the onset of the crisis. As a result, Romania had large twin deficits at the start of the crisis, specifically a sizeable structural fiscal gap (around –8% of GDP in 2008) and a current account deficit in the double-digit area (between 2006 and 2008).

After the crisis hit, Romania had no other choice but to undertake the necessary adjustments in order to eliminate these imbalances in an orderly manner. The efforts seem to have already paid off – the year 2013 marked a turnaround in Romania's economic development: economic growth of 3.5% driven mostly by robust export and industrial output on the supply side; a small current account deficit; historically low inflation; while the fiscal deficit was kept well below 3%. And I have every reason to believe that Romania will see further growth in the years to come. And that, unlike in the pre-crisis period, this time sustainability will be the name of the game, as hopefully we all have learned our lessons from our previous mistakes. As they say, no one really learns but from his own mistakes…

Talking about sustainable economic growth, one needs to put things into perspective in order to ascertain whether the economy is on the right track. This means that short-term policies must be harmonised with the long-term vision and goals.

Euro adoption could serve as such a long-term goal. And Romania has chosen to use it as an anchor. Let me say a few words about this subject.

In the post-crisis period, all non-euro area EU countries in Central and Eastern Europe with floating exchange rate regimes (Czech Republic, Hungary, Poland and Romania), as well as Bulgaria, shifted to a wait-and-see approach as regards euro adoption, even though, in some of them, Maastricht criteria were already fulfilled or within reach.

Nobody disputes that in the long term it is in the best interest of our countries to adopt euro, as it heightens the degree of business cycle correlation and market integration. However, the benefits of euro adoption are not unconditional; therefore it is essential to make sure that nominal convergence criteria are achieved on a sustainable basis. Also it is important to attain a certain degree of per capita income convergence before switching to the euro (a large convergence gap may complicate business cycle management in the absence of independent monetary policy). Additionally, it is important to demonstrate the effectiveness of the new institutional setup in preventing and dealing with pending imbalances and that alternative policy instruments exist in order to take over from monetary policy in case corrections are needed.

This is why recent years' experience has substantially altered the approach to euro adoption. Before the crisis, the opinion prevailed that meeting nominal criteria was enough to prove the eligibility for the euro adoption. Some economists even debated the excessive severity of the nominal criteria and the conflict between their fulfilment and real convergence progress (Buitter and Grafe, 2002; Szapary, 2001; Kopits, 1999; Rostowski, 2002). But during and after the crisis, it became obvious that the Maastricht criteria are not enough to ensure successful EA membership. Nominal convergence criteria cannot be sustainably met unless competitiveness, financial stability and solid fiscal equilibrium are ensured. "The bigger picture", meaning the Macroeconomic Imbalance Procedure, gained ground and real convergence criteria came to the forefront.

The other side of the story has shown us that during the last couple of years, the euro area underwent extensive governance reforms, designed to address the flaws revealed by the crisis. However, their actual effectiveness is still to be tested in practice. We are still in unchartered waters. There have been recent statements referring to the fact that Europe might have not exited the crisis yet. As Jean Monnet used to say: *"Europe would be built through crises"* and would be *"the sum of their solutions".*

Consequently, non-member States from Eastern and South-eastern Europe seem closer than ever to complying with the Maastricht criteria, but readiness for successful Euro Area membership needs further work. Labour, product market and other structural reforms are still required in order to observe convergence not only in letter, but also in spirit. Non-member States, on the road towards euro adoption, have to both comply with the Maastricht criteria and to choose the right moment for it. Each and every Member State should put their houses in order as a prerequisite for a successful Euro Area enlargement. Only this way new candidates will be able to obtain the opportunities of a single currency, while being in turn a valuable contributor to the monetary union.

Romania has recently reached political consensus, at the highest level, namely the President and the Prime Minister, that the target date for euro adoption will be January 1st, 2019. The rationale for this decision is that such an objective – feasible, yet ambitious – could act as a catalyst for coherent policy action.

At this point in time, Romania is fulfilling three out of the four Maastricht criteria, namely the sustainability of the fiscal position, convergence of long-term interest rates and exchange rate stability (although we are not technically in ERM II). Meeting the price stability criterion is probably just a matter of months, until the recent low inflation numbers feed into the 12-month average rate used as a reference.

But, we are fully aware that we still have a long and difficult road ahead, as several years of relentless efforts are needed in order to ensure a lasting fulfilment of the Maastricht criteria, to make further progress in the catching-up process in the area of real convergence, as well as to push forward the structural reforms required for enhancing the resilience and flexibility of the domestic economy.

Closely linked to the euro adoption approach is the decision on participating in the Banking Union, which is supposed to break the negative feedback loop between sovereigns and banks. Euro adoption automatically implies Banking Union membership and therefore, since the changeover target date has already been set, joining the Banking Union is merely a matter of timing: should it occur on the euro adoption date or as soon as possible?

In my opinion, there are strong arguments in favour of rapidly joining the Banking Union. First and foremost, the project itself is still work in progress and it is always advisable to partake from the inside in the construction of a mechanism that we will eventually have to join anyway. Secondly, with the Banking Union in place, the domestic financial system will be affected regardless of whether Romania is a member or not, so it is better to have a say in the decision-making process that generates such effects, since the latter will impact us one way or another. Besides, Banking Union membership is expected to benefit participating countries through the removal of an incentive for deleveraging on the part of foreign banks, more effective supervision by improving access to information and eliminating the possibilities of jurisdictional arbitrage, as well as the creation of a more competitive market by reducing distortions and entry barriers. Given the share of foreign capital in Romania's banking system, it makes even more sense to support the project.

In light of the above, Romania aspires to be part of all three pillars of the Banking Union. It is our view that adhering to this European project will strengthen financial stability, further increase confidence in the national banking sector (through the harmonisation of supervisory practices and deposit guarantee schemes), as well as foster sustainable lending and economic growth (by reducing the fragmentation of the European financial markets).

I shall stop here, thanking you for your attention. I wish you a fruitful outcome of the conference, and hope you enjoy your stay in Bucharest!