Mugur Isărescu: The single currency – a central banker's viewpoint from an EU Member State outside the euro area

Opening speech by Mr Mugur Isărescu, Governor of the National Bank of Romania, at the 2015 COFACE Country Risk Conference, Bucharest, 29 April 2015.

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Dear Professor Issing,

Ladies and gentlemen,

I am delighted to have the honour of opening this conference, the more so as this is an opportunity to meet Professor Issing again – the similarity of our surnames brought us literally side by side at many events over the years. Professor Otmar Issing's career is stupendous, but it is only natural that the general public has been remembering him as a prominent figure of the European Central Bank, whose inaugural chief economist he was, and as a key contributor to the building of the Economic and Monetary Union.

I. Euro adoption by Romania: between desirable and feasible

My intention today is to speak about the issue of the single currency from the viewpoint of a central banker in an EU Member State still outside the euro area. During my address, it is inevitable to touch upon various opinions which our distinguished guest has expressed over the years.

I start by recalling what Otmar Issing said back in 2006, in a dinner speech occasioned by his leaving the ECB: "We were all privileged to participate in a historically unique experiment: the creation of a new currency for Europe. We had to manoeuvre through uncharted waters and we may not yet have arrived in the Promised Land". I take these words as a prophecy, made in those heydays, when things seemed to move into the right direction all by themselves. The outbreak of the global crisis had not yet exposed the fracture lines of the European construct, which originated in the incomplete institutional architecture of the Economic and Monetary Union, as reflected by the weakness of fiscal rules and the absence of transnational instruments to monitor cross-border private capital flows. Many a times I heard Professor Issing talk about the need to address the vulnerabilities of the monetary union project, particularly in the area of public finance, where monetary policy more than often overlaps politics.

To what extent the Eurozone is now closer to the Promised Land than in 2006 is debatable. On the one hand, euro area enlargement continued at a sustained pace, so that it now encompasses 19 countries from 12 originally. On the other hand, for the non-euro area EU Member States, recent experience has made the benefits of euro adoption become less visible than its costs. Thus, in the pre-crisis period, euro area membership was seen as automatically delivering lower risk premiums, thereby helping achieve faster growth rates. In retrospect, the then benefit should not be viewed otherwise than as a consequence of improper risk assessment – financing costs for several euro area member countries have been exceeding those of some non-euro area Member States, Romania included.

Obviously, not only the developments in the Eurozone, but also the progress in non-euro area countries contributed thereto. As for Romania, I cannot refrain from underscoring that, while in 2008 the country did not fulfil any of the Maastricht criteria (the only indicator below the reference value was that on government debt, which is part of the fiscal sustainability criterion), today it is a frontrunner in terms of macrostability. This refers to the fulfilment of the nominal convergence criteria and the observance of the reference values in the scoreboard for the surveillance of macroeconomic imbalances (net international investment position is the only indicator in excess of the reference value, the same as in all new Member States).

This is the right time to reassess the schedule for euro adoption, especially in the context of the governance framework reform that is underway in the euro area and of the wait-and-see approach of other non-euro area Member States (I am referring to Central and Eastern European countries, namely Bulgaria, the Czech Republic, Croatia, Poland and Hungary). We should ask ourselves whether setting a target date is a good idea. The answer would be: yes, to the extent that it helps reach political consensus, while also providing a policy anchor by rendering macroeconomic policies more coherent and acting as a catalyst for structural reforms. However, in case the target date turns unrealistic or the formal commitment is not accompanied by a roadmap with clearly defined intermediate objectives, the credibility of euro adoption is rightfully questioned and the process loses its positive features mentioned above.

We cannot speak of euro adoption and sustainable nominal convergence without referring to real convergence as well. Even though the latter lacks a clear-cut definition and quantitative benchmarks, attaining a sufficient degree of real convergence is an important parameter for successful euro area membership, since it minimises the risks associated with abandoning monetary policy independence. This is all the more important as euro adoption implies, in the words of Professor Issing, a "permanent commitment". From this perspective, the two types of convergence are mutually reinforcing: nominal convergence provides the stable macroeconomic environment that fosters real convergence, while the latter lays the groundwork for sustainable nominal convergence by reducing the economy's exposure to asymmetric shocks and containing differences in the transmission of symmetric shocks. It is, however, of the essence that the pursuit of real convergence gains should not be governed by a short-term vision, in which case they would come at the cost of macroeconomic imbalances.

II. Is Romania prepared for ERM II?

Professor Issing is going to speak today about the global currency war, about whether we are indeed witnessing a genuine clash of currencies, as well as about the consequences of the massive exchange rate swings. It is a topical issue, also relevant to Romania, because the reshaping of the relations among major global currencies – including on the background of the ECB's recent quantitative easing – complicates the task of identifying the equilibrium exchange rate of the leu suitable for ERM II entry and thereafter for euro adoption.

Technically, the adoption of the single currency as of 1 January 2019 would imply joining ERM II in 2016 H1 and the minimum two-year stay. Aside from the difficulty of setting the central parity, ERM II participation calls, however, for a certain preparedness of the economy as well, considering the risks inherently posed by a target-band regime. The need to minimise such risks and the requirement to fulfil the Maastricht criteria by the end of the second year of ERM II participation render all the more important the completion of major economic policy adjustments ahead of adopting this exchange rate regime. I am mainly referring to removing the sources of repressed inflation (the relevant example being the completion of the energy market deregulation), of quasi-fiscal deficits (by restructuring loss-making state-owned enterprises), as well as other sources of future budgetary pressure (for instance, the unavoidable expenditures to modernise road infrastructure). There are also monetary adjustments that need to be carried out ahead of ERM II entry, namely finalising the process of bringing minimum reserve requirement ratios in line with euro area levels. The large volumes implied by the cut in reserve ratios and the potential impact on the exchange rate call for a gradual approach to this process, possibly spanning one year to one year and a half, which is yet another reason why ERM II entry in 2016 and hence euro adoption in 2019 are highly ambitious goals.

III. The rationale behind other EU Member States' wait-and-see approach to euro adoption

In fact, Romania is the only non-euro area EU Member State that has set a target date for the adoption of the single currency. The other countries show a prevailing wait-and-see approach, driven not necessarily by the difficulty to observe the limits provided for by the nominal convergence criteria (generally achieved or within reach), but rather by a fundamental change in the overall approach to euro adoption. This occurred amid the benefits of euro adoption becoming less obvious and the costs more apparent.

I have already pointed out at the beginning of my speech the fading benefits that euro area membership provided in terms of financing costs. Additionally, the benefits of trade integration, previously deemed as irrefutable, have been drastically diminished by the weak euro area growth.

As for the costs of euro adoption, Central and Eastern European economies with floating currencies went through relatively milder economic contractions than those with fixed exchange rate regimes, which highlighted the relevance of this element of policy flexibility. It has become clearer than ever that early euro adoption is undesirable, at least from this standpoint.

Furthermore, direct costs have emerged in relation to euro area membership, arising from the sovereign debt crisis and the establishment of resolution mechanisms. Bearing such costs entails not only additional financial efforts. It is politically difficult to justify to the general public the need for financial contributions to mechanisms that richer countries currently benefit from (the collapse of the Radičová Cabinet in Slovakia in 2011 is illustrative in this respect).

Another argument for the reluctance to set a target date for euro adoption is also linked to the fact that the euro area, unlike the European Union, appears not to have been a convergence club for its members. Hence, the standard deviation of GDP/capita at PPS relative to the group average indicates higher disparities among countries part of the initial euro area setup, while homogeneity in terms of income has been increasing across the EU. In my opinion, this state of affairs does not rule out the success within the euro area, but merely highlights that it can be achieved only under certain circumstances (the prior achievement of a sufficiently high economic development level and coherent macroeconomic policies). The thorough preparation of euro adoption is therefore essential, so as to ensure the sustainable compliance with nominal convergence criteria, because a single currency area is no place for economies with competitiveness issues or rigid markets.

Last but not least, the changes to the euro area governance framework for solving the deficiencies highlighted by the crisis need to stand the test of applicability. Only one year ago, Professor Issing insisted that the euro area prosperity was conditional on the observance of the rules of the club by its members. The turn that the Greek crisis has taken is relevant for the effectiveness of the new institutional architecture of the euro area. Unfortunately, the expectations that the Riga Summit should bring us closer to an orderly resolution have not been confirmed.

IV. Should we be concerned, should we think positively or should we use our sense of humour?

Currently, the debates over the present and future of the euro area are dominated by the assessment of the situation in Greece. For us, as EU members having not yet joined the euro area, these debates also raise the question of whether we should be very much concerned or take a positive, constructive approach. Although the trials and tribulations caused by the situation in Greece have often been described as a conflict between two totally different mentalities – namely, the Teutonic strictness versus the Levantine easygoingness – my view is that it is an overstatement, just like any generality. I remember the speech our distinguished guest delivered at the end of his ECB tenure and the fact that the closing remarks showed not only a good sense of humour, but also a subtle comprehension of the manner in which physical distances and especially distances in time alter the assessment of individuals and, if I may add, of events. Please allow me to read the final part of the aforementioned speech, which presents the timeline of the news published by *Le Moniteur* concerning the return of Napoleon from his exile on Elba Island:

10 March – "The Corsican ogre has landed at Cape Juan";

11 March – "The tiger is in Gap. Troops are on their way and will stop him. He will end his miserable adventure as a homeless refugee in the mountains";

12 March – "The monster succeeded in proceeding to Grenoble";

13 March – "The tyrant is now in Lyon. Horror has caught the people";

18 March – "The usurper is some days' march distant from Paris";

19 March – "Bonaparte approaches in a hurry, but he will not succeed in advancing to Paris";

20 March – "Napoleon will be in Paris tomorrow";

21 March – "Emperor Napoleon is in Fontainebleau";

22 March – "Yesterday evening His Majesty celebrated his arrival in Paris. The jubilation cannot be described".

At the end of his speech, referring – with an irony that shows a keen sense of human nature – to how the public might change its future perception on his activity, Professor Issing added: "I can only hope that in my modest case the reversal of the sequence of events does not end where the news on Napoleon started".

For me, a European of Latin origin living at the gates of the Orient, this excerpt does not reflect the so-called German rigidity whatsoever, but rather a healthy, accommodating sense of humour, which is part, I hope, of the new European culture.

Turning back to the euro area tensions generated by the situation in Greece, the future definitely holds new surprises in store for us. One never knows who the next ogre may be…

No matter how much uncertainty surrounds any prediction, I would rather conclude my presentation today on a positive note, by recalling the words of Jean Monnet, one of the founding fathers of the EU project, who thought that "Europe will be forged in crises, and will be the sum of the solutions adopted for those crises". I only hope that policymakers in Europe have learned their lessons well enough from treading the desert of the crisis so that it has taken us closer to that Promised Land Professor Issing was mentioning. If I may continue along the lines of the Bible, as the Tablets of Law preceded the arrival in Canaan, we should not forget that we will get there no sooner than all club members have not only formally accepted, but also made their own, the rules underlying the monetary union.