Mugur Isărescu: Developments in the Romanian economy since 2008

Speech by Mr Mugur Isărescu, Governor of the National Bank of Romania, at the "Romania Investors Days" conference, Bucharest, 16 June 2015.

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Ladies and gentlemen,

I am happy to witness the growing interest the investors' community is showing towards the Romanian economy. Since this is the first reverse roadshow focused on Romania, I hope it will prove fruitful for all parties involved and that it will be followed by other similar events.

In my address today, I intend to briefly touch on the most relevant developments in the Romanian economy and I guess you will agree with me that we have come a long way since the beginning of the crisis.

Probably the most synthetic assessment of the transformation is given by the fact that, at the onset of the crisis, Romania fell short of all four Maastricht criteria – inflation, long-term interest rates, public deficit and debt, exchange rate stability –, but now they are all fully met. Up to 2008, Romania was going through a period of fast economic growth (in excess of 7 percent per year, on average), fuelled by large capital inflows and the strongly pro-cyclical stance of the fiscal policy, especially in the last two years before the onset of the crisis. Unfortunately, this came at the cost of significant macroeconomic imbalances: at the start of the crisis, Romania had a sizeable structural fiscal gap (around –8 percent of GDP in 2008), a current account deficit in the double-digit area and high inflation readings.

When the crisis hit, there was no other option but to make the necessary adjustments. They appear to have produced the expected results: with the current account deficit below 1 percent of GDP, a structural fiscal position in the vicinity of 1 percent of GDP, and an annual inflation rate currently at 1.2 percent, we can safely say macroeconomic equilibria have been restored. At the same time, the economy resumed its growth at rates that can be regarded as robust when compared with the European performance (around 3 percent in both 2013 and 2014 and an even better 4.3 percent in the first quarter of 2015). As a consequence, the output lost in the first two years of the crisis has been completely recovered. Public debt is currently below 40 percent of GDP and looks set to decrease over the medium-term, assuming fiscal consolidation gains are maintained and the economic growth stays at current levels.

Positive developments also occurred in terms of the external debt, whose share in GDP decreased by more than 12 percentage points since 2012, mainly due to the cross-border deleveraging and the near complete repayment of the IMF loan. Nevertheless, international reserves, which currently stand at EUR 33.8 bn, continue to provide comfortable coverage as measured by most available metrics (above 6 months of prospective imports, around 100 percent of the short-term external debt at residual maturity, almost 60 percent of the money supply).

While Romania seems to have wrapped up the period of macroeconomic adjustments, the future mission of economic policies is to keep the economy on an upward trend without putting at risk the balances restored with so many efforts. As in many other European countries, the emphasis now falls on structural reforms meant to boost the economy's growth potential in the long run, enhancing its flexibility and resilience to shocks.

As a central banker, I am perfectly aware that one cannot talk about a sound economy and sustainable economic growth without a solid financial system. Speaking about the banking system, the soundness of which has been entrusted to the central bank, I would first say that it has successfully weathered the crisis, without any resort to public money. Not only is the system well-capitalised, as shown by the 18.6 percent total capital ratio in March 2015, but good-quality capital prevails, given that the tier 1 capital ratio stands at 16.1 percent. Both levels comfortably meet the new Basle III capital requirements. Moreover, banks made real progress in cleaning up their balance sheets over the last year, bringing the aggregate NPL ratio down from levels above 20 percent in 2014 Q1 to around 13 percent currently.

As elsewhere in Central and Eastern Europe, in Romania too the vulnerabilities exposed by the crisis in the model of centralised fund management at the level of cross-border banking groups led to a new paradigm, which emphasises the local funding of credit activities. The cross-border deleveraging which accompanied this switch, while sizeable, has nevertheless unfolded in an orderly manner.

The shift towards the domestic market in terms of financing sources was accompanied by an increase in the relative importance of local currency-denominated loans: after a long time, their share exceeded 45 percent and will possibly overtake foreign currency lending by the end of the year. This is, undoubtedly, a positive development for both debtors, who avoid currency risk exposure, and central banks, due to the increased effectiveness of monetary policy.

Looking ahead, the constraints on both credit supply and demand are expected to continue to prevail, as the effects of a balance-sheet crisis, such as the one we have recently encountered, tend to be longer-lasting. In such an environment, the quality of credit allocation appears more important than the volume, although the latter is not at all irrelevant in our case given a still low financial intermediation at 31.7 percent of GDP (not even during the credit boom period did it exceed 40 percent).

In order to put the economy onto a self-sustained growth path, I believe it is necessary for banks to channel credit to productive investment, avoiding the overburdening of good debtors with the costs of past misallocations. Such an approach should generate the productivity gains that are essential for credit, investment and productivity to fuel each other and place the economy onto a sustainable uptrend.

Let me now turn to monetary policy. The countercyclical stance during the boom years allowed monetary policy to turn stimulative after the outbreak of the global crisis: the policy rate has been gradually cut from 10.25 percent at the beginning of 2009 to 1.75 percent currently, while the reserve requirement ratios have been lowered to 8 and 14 percent for lei- and forex-denominated liabilities respectively. While it is obvious that the NBR did not have to navigate in the uncharted waters of quantitative easing and negative nominal interest rates, there are still challenges to cope with.

I would list first the difficulty in designing monetary policy in a context of rapidly improving cyclical position of the economy, while a perfect storm of favourable supply-side shocks – namely oil and food price drops and indirect tax cuts – has been generating low inflation readings for quite a while now, with the potential to alter inflation expectations in the medium term.

Furthermore, the already mentioned constraints on credit supply and demand still impair the transmission mechanism of the monetary policy. Specifically, even though the interest rates on new loans in domestic currency have declined further in response to the policy rate cuts, the annual growth of credit to the private sector has leveled off in recent months.

Aligning the operational framework of monetary policy to European standards is another challenging objective the central bank faces. Obviously, I am talking about the still high reserve requirement ratios (given the need to contain credit expansion, foreign currency lending in particular, during the economic boom) and the relatively large width of the interest rate corridor (initially warranted by the imperative of cooling off speculative capital inflows and domestic currency appreciation). The NBR has capitalised, in the past two years, on the window of opportunity provided by the favourable macroeconomic and financial background to rectify the situation to a large extent, yet the process needs to be continued until reaching the prevailing levels across the EU. Looking ahead, it is essential that the NBR identify, as it has until now, the right timing for the upcoming stages of the alignment process to unfold without impairing the smooth functioning of the markets and without deteriorating key indicators for investor sentiment or, more generally, public perception.

I will end my brief overview on the economic state of play in Romania by expressing my hope that this event will turn out to be the beginning of a lucrative and mutually beneficial partnership.