Mugur Isărescu: Romania - post-crisis performance and current challenges

Speech by Mr Mugur Isărescu, Governor of the National Bank of Romania, at the AmCham CEO Forum, Bucharest, 31 May 2019.

* * *

Accompanying slides of the speech.

Ladies and gentlemen,

I am honoured to address, this morning, such a distinguished audience. I have gladly accepted your kind invitation, for AmCham Romania has become, during the last 25 years, an important voice of the business community, speaking on behalf of many US-based, international and local companies that are doing business in Romania, and promoting its members' best practices.

1. GROWTH, CONVERGENCE AND SUSTAINABILITY

I am aware that, when talking to business community representatives, more than to other categories of public, the topic of economic growth, with all its determinants, trends, uncertainties and tensions, is of great interest. Indeed, Romania's post-crisis performance has been impressive: average annual growth rate of 4.6 percent in the last five years. Romania's economy is constantly growing, yet some tensions surround the macroeconomic equilibria.

The advance seen in recent years was primarily driven by consumption that benefited from a loose fiscal and income policy, coupled with a tight labour market profile, which additionally spurred wage growth. The pass-through of consumption to output was nevertheless limited by the weak competitiveness position of some local industries on the domestic market, so that high consumption rates were accompanied by strong imports. Thus, in spite of high export growth rates, net external demand has not made a positive contribution to the GDP advance since 2013. Instead, this caused a significant current account deficit widening.

Therefore, in order to preserve the GDP growth trend, economic policies should focus on its sustainability. In the quest for supporting potential growth and increasing the resilience of the economy, there is no substitute for a coherent mix of macroeconomic policies and structural reforms.

A durable economic growth is extremely important also from the perspective of euro adoption, as it would lead to progress in convergence, which will put us on the right track for achieving the goal of joining the Eurozone. In order to stay on course, economic growth and convergence must advance in line with economic fundamentals. Otherwise, the gains, as spectacular as they might be, could be jeopardised by abrupt setbacks. At the end of the day, forcing convergence or postponing convergence is equally harmful.

I had the honour to be one of the vice-presidents of the *National Committee for Substantiation of the National Euro Changeover Plan*, founded last year, which prepared a set of documents that emphasise the need for a substantial degree of convergence before entering the euro area. In fact, it is the Maastricht Treaty that explicitly stipulates the need for "a high degree of sustainable convergence". Yet, this requirement seems to have been overlooked sometimes.

Let me point out that by *convergence* I refer to *all four types of convergence* that must be taken into account: nominal, real, institutional and structural. Nominal convergence is easily quantifiable, as the specific criteria are clearly defined in the Maastricht Treaty. But we also have to ensure the compatibility of our institutions with those in the euro area and this is the essence of institutional convergence, a process where the central bank and its independence are particularly important. While structural convergence focuses on adapting the structure of our economy to that of the euro area, real convergence, measured by GDP per capita (at PPS) as a percentage of euro area/EU average, is the best proxy for the development level of a nation.

Romania has certainly come a long way in terms of economic convergence, a process whose inception is tied to the prospects of EU membership, witnessing a significant increase in per capita GDP as a share of the euro area average (based on PPS), from 31.3 percent in 2005 to 60.4 percent in 2018. Peer countries recorded a similar trend: Bulgaria went from about 33 percent to 47 percent, while Czechia, Hungary and Poland, which started from a more advanced level, added 11 to 23 percentage points to the same indicator during 2005–2018. However, this process is still far from completion in these non-euro New Member States.

Talking about real convergence, practical experience has showed us that the Eurozone is not a “convergence club”, as its members did not necessarily improve their real convergence after joining it. The euro area is not a cosy place for economies with lagging competitiveness or rigid markets. In this context, a high enough level of real convergence (in addition to the compliance with the nominal convergence criteria) is needed when joining the euro area, to limit the costs associated with losing monetary policy independence.

A high enough level does not mean that we are so ambitious as to aim for a convergence level of 90% of the Eurozone average or a level equal to that of Germany (as is the case with certain approaches put forward in Hungary or Poland). However, we need to achieve a real convergence level of at least 70–75 percent of the Eurozone average. Otherwise we would be insufficiently developed and, therefore, vulnerable to asymmetric shocks and unable to synchronise our business cycle with that of other euro area economies. However, we must take care that the level of convergence increases in a sustainable manner. We should be able to preserve the pace of this process, and once steps forward have been made, we may not stop or go backwards. Past achievements in nominal and real convergence, while significant, do not guarantee future success. To this end, allow me to bring up an old, but reliable principle. The Latin saying *festina lente* is perfectly suitable in this case: hurrying in a slow manner, if I can say so, on the convergence path means achieving a sustainable pace in the medium and long term. In other words, we need to be *a marathoner*, and not *a sprinter*.

Our commitment to join the euro area is indisputable, yet this process has to be managed in a very careful manner.

2. FINDING THE RIGHT BALANCE BETWEEN CONSUMPTION AND INVESTMENT

During recent years, the contribution of investment to growth was smaller than it should have been, with consumption spending being the main driver of GDP dynamics. Welfare has increased markedly, but the concern for rendering these welfare gains sustainable should prompt a switch to policies aimed at fostering investment, thus boosting the productive potential of the economy.

A short-term focus on economic policies and paying no heed to accumulating macroeconomic disequilibria ought to be avoided, as they eventually lead to suboptimal outcomes. The adequate approach is to ensure a rebalancing between consumption and investment, not by discouraging consumption, but by stimulating investment.

This is also a way to reduce development gaps between Romania’s regions. Indeed, the EU accession acted as a catalyst for real convergence at country level, yet development imbalances in Romania did not decrease significantly. Romania currently has regions that are similar in terms of living standards and development levels to Western economies, while some other areas are considerably lagging behind: in 2017, the wealthiest region in Romania was almost four times richer than the poorest one (based on regional per capita GDP). Therefore, even though the EU membership has acted as a catalyst for country-level real convergence, the development gaps across the regions of Romania have actually increased. Such a status quo is not beneficial, for instance, in the context of euro adoption, as it favours asymmetric shocks and uneven effects of public policies.

These imbalances can be mitigated, first and foremost, through investment in infrastructure. For instance, the construction of highways is essential for connecting Romania's regions, encouraging regional trade and investment, with favourable effects on regional development and cohesion inside the country.

3. LOOKING FOR A WAY OUT OF A LABOUR MARKET DILEMMA

Another area that deserves particular attention is the labour market, at a time when the Romanian one is facing considerable challenges. As a catching-up open economy, within a European Union based on the free movement of capital and labour, our country was bound to find itself in a dilemma sooner or later. More precisely, there are contradictory arguments with regard to the adequate path of the wage level in the Romanian economy. On the one hand, wages should be governed by productivity dynamics, so as not to erode the competitive position. On the other hand, they cannot be considerably below those in other economies, as this would simply result in a labour force drain, with dramatic consequences if not addressed quickly. Specifically, we are facing an emigration problem today, as more than three million Romanians (a significant percentage of the population) have left their homeland for other EU Member States. Therefore, to limit emigration, wages should increase. As noted above, the only way to do that without hindering competitiveness is to boost productivity.

Foreign direct investment has helped total factor productivity in recent years, yet if wages reach too high levels, attracting investment may become a problem. We therefore need to ensure that wage levels are compatible with attracting investors, but at the same time acknowledging that, at least in certain areas, wages need to go up at present, in order to mitigate the labour force drain that affects the private and public sectors alike. However, pay rises in the private sector should not be triggered only by an increase in public sector wages. While raising the minimum wage has been necessary, we should be very careful not to hurt employers, as they represent an important engine of the economy.

The key is, in my opinion, to increase wages at an adequate, sustainable pace, in order for Romanians to ultimately benefit from an improved living climate reflected in a higher purchasing power, but also from preserved macroeconomic equilibria, as well as higher-quality public goods – especially highways connecting different regions of Romania, but also our country with the West. After all, wages are not the only side of the emigration story.

4. KEEPING THE EXTERNAL DEFICIT IN CHECK

The wage matter is also closely linked to the topical issue of ensuring a balanced external position. To the extent to which the upward path of wage costs is too steep, it gets very difficult to preserve competitiveness, not only on external markets, but also on the domestic market. If the Romanian companies are unable to gain market shares in the tough competition with rivals on both aforementioned markets, the gap between imports and exports widens, causing the deepening of the trade deficit and hence of the current account deficit; the latter is already at a level that raises concerns, also in terms of its financing by flows deemed stable (such as FDI and European funds), which have no longer fully covered it.

Romania's sizeable external imbalance is singular in the region in terms of size and trend. It owes to the faster growth of domestic absorption than that of domestic output, as well as to non-price competitiveness issues of the Romanian economy manifest in certain production sectors. Relevant from this perspective is the unfavourable comparison with Czechia, Poland and Hungary, three countries where, the same as in Romania, monetary policy is managed under the inflation targeting strategy and there is a floating exchange rate in place.

Speaking of the exchange rate, I cannot help mentioning that the hasty adoption of Government Emergency Ordinance No. 114 at the end of last year contributed, through the uncertainty created on the market, among others, to an episode of moderate depreciation of the domestic currency in January 2019. Thus, the relative stability of the exchange rate of the leu, which we have all got used to, was a bit affected. Obviously, a certain flexibility margin in its evolution is natural, but allow me to point out that it is not the exchange rate that should act as a correction tool for the external imbalance, which can be rather mitigated by way of structural reforms and fiscal adjustment.

In this context, it is also worth underlining that it is important to avoid a significant appreciation of the leu, which might be induced by a too high interest rate differential versus peer countries. In Czechia, Poland and Hungary, the monetary policy rate is substantially lower than that of the NBR, which the Board meeting of May 2019 kept at 2.5 percent, along with tightening control over money market liquidity. A widening of the interest rate spread vis-à-vis these countries might attract volatile capital inflows, conducive to an excessive strengthening of the domestic currency. Let me also point out that, in all three countries mentioned above, policy rates stand below the inflation rate, the same as in Romania. And precisely because – as the business community knows too well – we are not cut off from what is going on around us, the NBR's monetary policy stance should be assessed in a regional context as well.

To sum up, it is essential to keep macroeconomic imbalances in check and promote structural reforms so that the Romanian economy does not witness major vulnerabilities in a global environment marked by so many uncertainties. It is by no means an easy task to make forecasts in such an environment, but one thing is sure: it takes a lot of economic policy wisdom to sail safely in waters that are not exactly tranquil. As one of the most outstanding US presidents, Abraham Lincoln, once said, “The best way to predict your future is to create it”.

Thank you for your attention!