Mugur Isărescu: 15th Anniversary of the 2004 EU Enlargement - looking back, looking forward

Opening speech by Mr Mugur Isărescu, Governor of the National Bank of Romania, at the conference on the 15th Anniversary of the 2004 EU Enlargement: Looking back, looking forward, National Bank of the Republic of Austria, Vienna, 8 April 2019.

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Governor Nowotny,

Distinguished audience,

Ladies and gentlemen,

I am greatly honoured by the invitation to address this audience at a time when we celebrate the 15th anniversary of the first wave of EU enlargement. This event gives me yet another opportunity to say a few words about Romania, a country that I know very well. Romania was a second wave country, the same as Bulgaria, but I am familiar with the case of the first wave countries because I watched their course of development and I must say they paved our way to EU membership. I will look back at Romania's journey on the path of European integration, while also reminiscing the entire transition from communism to democracy and from a centralised economy to a market economy.

I believe discussing this subject is useful, since the lessons and challenges of the past have been quite numerous and some of Romania's peculiarities might be relevant for other countries. Speaking of the past, I cannot help remembering that in the early nineties, when I took over as Governor of the National Bank of Romania, a tremendous effort was needed – not only in Romania, but also in the other former communist countries in Central and Eastern Europe – to go from a monobank-type system to a two-tier system. The effort was even bigger in a country like Romania, where – after some attempts to implement reforms in the sixties and seventies – the economic and financial system had become ever more centralised, more Stalinist-like in the final decade of the communist regime.

In hindsight, now that things have settled, these changes may seem like a piece of cake, but please try to imagine how difficult it was to take the reins of an institution that had operated in the context of centralised state planning of the entire economic activity. There was no trace of monetary policy and commercial banking operations needed to be separated from central bank operations. The former were taken over by Banca Comercială Română, later part of the Erste Bank group, while monetary policy became the responsibility of the National Bank of Romania. The "parting of the waters" occurred pretty quickly, but the new NBR only accounted for less than 5 percent of the former central bank employees, most of them in cash management and accounting. Therefore, key departments to the functioning of a modern central bank, such as monetary policy, economic research, banking supervision and regulation, had to be built from scratch.

As we have come a sufficiently long way to remember this with a smile on the face, I would like to share with you two amusing stories I deem illustrative for the hardships of the beginning. One dates back to the autumn of 1990. Having been recently appointed at the helm of the National Bank of Romania, I held a press conference during which I stated that the banking system would operate on two tiers or two floors, with the central bank on the first floor and commercial banks on the second. The head of the institution's commercial banking operations – the same person who would later manage Banca Comercială Română after its separation from the National Bank of Romania – took these words literally and immediately complained that he had just moved to the first floor of the building and warned me that he had no intention of moving again!

At around the same time, in the early days of my term in office as Governor, someone "encouraged" me with the words: "Welcome and good luck running an empty bank!". Unfortunately, the trials and tribulations of the first post-communist year had practically depleted the country's foreign exchange reserves in nine months' time. I confess that I then felt the need to go to the vault and feel with my own hands the gold bars – Romania's last tangible reserve in those days (in December 1990, gold reserves stood at 68.7 tonnes, amounting to approximately USD 850 million) – for a boost of confidence that the rather complex economic situation might be successfully tackled. It is hard to believe that this really happened, especially now, when Romania's international reserves amount to approximately 38 billion euros.

I will now move on to less amusing memories of those times. The avatars of economic transition rendered difficult the mission of Romania's central bank. Monetary policy, a fundamental task of the National Bank of Romania, was facing numerous difficulties and constraints, as the process of lowering inflation was often undermined by the need to pursue conflicting macroeconomic objectives or avert a full-blown banking system crisis. This was because Romania's path towards a functional market economy was anything but smooth. Quite on the contrary, the process often shifted between step-ups and slowdowns, that is when it did not stall altogether. A major feature of the domestic economy's reform was the priority given, at the onset of the process, to ensuring the country's social and political stability. In this context, the preferred choice was a gradual strategy, with reforms spread over many years, so as not to spark major social tensions. The reason for the gradual approach was that, in December 1989, Romania's regime changed in a dramatic manner, which was more painful than the experience of other former communist countries.

A completely different approach was noticeable, for instance, in Poland, where short-term concerns were left aside in order to create, from the very beginning, a climate conducive to lasting economic growth based on solid foundations. This shock therapy, delivered by the then finance minister Leszek Balcerowicz, who would later go on to become governor of the Polish central bank, kicked off by triggering extremely high inflation (its annual average rate nearing 600 percent in 1990), but afterwards enabled a relatively steep decline in inflation to moderate levels, where it stabilised.

In Romania, where the "shock therapy versus gradualism" dilemma was solved in favour of the latter option, such a feat in taming inflation would not have been possible in the early years of transition. The gradual liberalisation of prices, launched in the autumn of 1990, was broadly concluded no earlier than towards the end-nineties, which translated into perpetually high inflation rates. We named it corrective inflation, but it was difficult to explain repeatedly to the public that this kind of inflation was necessary. As a result, an inflationary climate became the norm in Romania. No matter which monetary policy the National Bank of Romania would have pursued at the time, the environment in which it was implemented was utterly unfavourable for ensuring price stability.

Moreover, the delays in the restructuring or privatisation of state-owned companies paved the way for high levels of arrears. Acting as surrogate money, they undermined monetary policy restrictiveness and fuelled inflation. In addition, the disequilibria manifest at the level of the current account could be adjusted only by purposely resorting to the exchange rate, whose depreciation generated inflation as well. As a matter of fact, other countries which, during one transition stage or another, had slowed down the engines of economic restructuring were also faced with such issues, recording a more modest macroeconomic performance. Going back to the comparison with Poland, I deem it relevant that the output loss associated with the structural changes implied by the transition to a market economy was fully recovered in 1995 in Poland, whereas in Romania this occurred a hefty nine years later.

Now, it is almost two decades since Romania – EU accession negotiations had been opened. Back then, in 2000, I served as prime-minister. In fact, I think I may say that my entire prime-

ministership in 2000 was dedicated to laying the groundwork for Romania's accession to the European Union. And it is worth noting that, if Romania managed to join the EU on 1 January 2007, all the inherent stumbles notwithstanding, the preparation process started in 2000 was essential. And it would have been dramatic if this start had been missed.

Back then, I convinced the EU officials, particularly Romano Prodi, the President of the European Commission, who visited Bucharest in January 2000, to have confidence in Romania's capacity to fulfill the accession conditions by 2007. That decision on Romania's entry into the European Union was a historical one, and gave further impetus to the transformation and modernization of the Romanian society in its entirety. The tumultuous years with ups and downs in the first post-communist decade were followed by seven good years (2000–2006), featuring substantial reforms, robust economic growth and gradual disinflation.

In this context, the wager made in 2000 was won: Romania, like Bulgaria, managed to become a EU member state in 2007, in the second enlargement wave, only three years after the group of countries the accession of which we are now celebrating. And the medium-term development strategy adopted back then proved to be an effective roadmap for Romania's European integration.

Romania has been an EU member for more than 10 years already – a long time for important lessons to be learned. So allow me to share with you at least some of them, especially those that cover the complex topic of economic convergence.

Having clear prospects for entering the EU favored Romania's real convergence, acted as an anchor and a catalyst for reform, and led to great strides towards a functional market economy. This does not mean, however, that it was all a joyride, as we had our share of tough decisions to make.

In the run-up to the EU entry and a few years before the outbreak of the global crisis, the National Bank of Romania faced an economic and financial context that could be deemed as exceptional. Massive capital inflows occurred given the existence of a significant interest rate differential and abundant global liquidity, in the context of the gradual removal of capital controls due to the requirements of the forthcoming EU membership. This led to a rapid rise in forex credit, a sizeable nominal appreciation of the domestic currency, and booming domestic demand.

In this case, trying to cool down the economy through the standard recipe of policy rate hikes would have been pointless, if not outright detrimental, by prompting even more capital inflows and nominal appreciation, thus creating a vicious circle. So the context called for the use of unconventional instruments. Such departures from conventional practices involved the full use of direct FX interventions, allowing market interest rates to fall significantly below the policy rate through liquidity management, the active recourse to reserve requirements and deploying administrative measures to control credit growth. To give you just a few examples, they involved enforcing a maximum loan-to-value ratio, introducing debt service ceilings relative to households' monthly disposable income (the scope of which was subsequently expanded to include non-bank financial institutions engaged in lending), setting limits to banks' forex exposure vis-à-vis unhedged borrowers, and using differentiated coefficients in stress tests (higher for EUR than local currency exposures, with even stricter coefficients for CHF- and USD-denominated credit). These measures were efficient, at least to some extent. Although sometimes circumvented by banks, they have managed to slow down forex credit growth, providing a wise solution to the problems faced at that time by our economy.

Back then, we referred to them as unorthodox monetary policy measures, but after the crisis, the IMF mentioned the National Bank of Romania as being among "the pioneers" of what later became "macroprudential instruments".

After the EU entry, the actual membership in this "convergence club" has fueled and enhanced

the catching-up process. Being in the EU meant free exchange of goods and services, along with the free movement of capital and labor, which increased trade, foreign direct investment, and migration flows, for the benefit of economic growth in our country. Moreover, in the long run, EU membership fostered convergence through investments from European funds.

Romania has certainly come a long way in terms of economic convergence, with growth resuming and gaining momentum after the global economic crisis: its GDP per capita as a share in the EU average (based on PPS) more than doubled from 30.6 percent in 2003 to 62.7 percent in 2017. The advance was the fastest within the group of peer countries that recorded similar trends: for instance, Bulgaria went from 32.4 to 49.3 percent, while Hungary, the Czech Republic and Poland, which started from a more advanced level, added between 7 and 22 percentage points to the same indicator during 2003–2017. To a certain extent, the speed of convergence was, in the case of Romania, fueled by the flexibility of our exchange rate regime. The movements in the leu exchange rate cushioned some unexpected shocks that hindered economic growth, keeping it at a higher level and avoiding excessive output volatility.

But, besides numbers and levels, I believe that the sustainability of real convergence is essential, especially for EU member states like Romania, for which the obvious next stage is joining the euro area. Indeed, to attain a certain degree of per capita income convergence before switching to the euro is essential, as a large convergence gap may complicate business cycle management in the absence of independent monetary policy. And, unlike the EU, the euro area proved it is not a “convergence club”, as its current members did not necessarily increase their convergence level after adopting the euro. But, while the optimal level of real convergence for a successful euro area entry is still a controversial issue, the consistency and sustainability of convergence are, in my opinion, at least as important as its level.

On this convergence path, I believe that it is very important to avoid divergence, even inside the country. In Romania, one can find areas that are comparable, in terms of development and living standards, to Western economies, but also regions that trail well behind: in 2017, the wealthiest region in Romania was almost four times richer than the poorest one (based on regional per capita GDP). So, 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.

Shortly after the EU accession, there was a surge in economic optimism, translating into an acceleration in economic growth, along with a credit and real estate boom. Despite the efforts of National Bank of Romania, which maintained a prudent policy stance, macroeconomic imbalances widened: the current account peaked in 2007 and remained in the double-digit territory in the next year. Unfortunately, fiscal policy poured more gas on the fire by switching to a strongly expansionary stance after EU accession.

Thus, when the global financial crisis hit Romania in the fall of 2008, the country had already expended all the bullets in its fiscal policy magazine and was in the unenviable position of having the second largest structural general government imbalance (around 9 percent of GDP) after Greece. There was no choice but to embark on a process of painful fiscal consolidation that was one of the largest and least gradual in the EU. Having prudently built policy buffers in the run-up to the financial crisis, monetary policy was able to maintain a countercyclical stance, yet it could not preclude a large contraction in aggregate demand in 2009 and 2010. Nevertheless, the ensuing correction in macroeconomic disequilibria created the conditions for resilient GDP growth and the loss in output was made up for by the end of 2014.

Currently, we are in our ninth year of consecutive economic growth. There are, however, several dimensions of recent growth that could have turned out more favorable. For instance, the contribution of investment to growth was smaller than it should have been, with consumption spending being the main driver of GDP dynamics in recent years. While there is no question that welfare has increased markedly, 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, so that future economic growth would not lead to further widening of macroeconomic imbalances. In the end, the lesson of the crisis is that a short-term focus in economic policies and paying no heed to accumulating macroeconomic disequilibria ought to be avoided, as they eventually lead to suboptimal outcomes.

The only way ahead is by means of a coherent macroeconomic policy mix and resolute structural reforms aimed to boost the growth potential of the economy, ensuring durable growth and enabling the economy to benefit from EU membership. In Romania, infrastructure investment should be a major policy focus, as it would contribute the most to reducing regional disparities while also allowing businesses to access underutilized labor resources – a particularly welcome development in the nowadays tight labor market. In terms of macroeconomic policy, it is beyond any doubt that countercyclical monetary policy favors smooth convergence. This has always been one of the guiding principles for calibrating the stance of the National Bank of Romania's monetary policy, as well as for developing and employing our policy tools.

We must continue on the road ahead keeping in mind that past achievements in terms of convergence, however large, do not guarantee future success (the middle-income trap is a real danger). For a sustainable economic convergence, we have to maintain a long-term perspective and implement coherent policies and reforms. Moreover, having ambitious but, at the same time, realistic anchors (such as the EU accession was for Romania before 2007) does help, as it gives purpose and direction to policymakers and society as a whole.

What we need in order to move forward on the convergence path towards euro adoption is, first of all, to understand there is no substitute for a coherent economic policy mix, which should remain so even in electoral years. Secondly, it is important that Europe remains united. As I recently stated in a speech held in Bucharest, whenever things seem to look bad, I remember the words of Jean Monnet, one of the EU founding fathers: "Europe will be forged in crises and will be the sum of the solutions adopted for those crises".