Mugur Isărescu: Transformation of Central and Eastern European economies - lessons learned and the way forward

Opening speech by Mr Mugur Isărescu, Governor of the National Bank of Romania, at the Bucharest Security Conference, Bucharest, 4 October 2019.

* * *

Ladies and gentlemen,

I am honoured to speak at this conference about a highly topical issue in front of such a distinguished audience. I believe it is a good opportunity to look back at the macroeconomic and financial developments in Central and Eastern European countries and, based on the past decades' experience, to look forward into the future of these economies, also from the perspective of euro adoption.

Generally speaking, the transition from a centrally-planned to a market economy proved to be a much more difficult task than it was first believed. The transition model was designed based on the concepts prevailing in the western countries in the early '90s: free markets, globalisation and ensuring security and development via NATO and EU membership. With the benefit of hindsight, I can say now that not many knew exactly what the right thing to do was, relevant experience was lacking, and every model – be it shock therapy or gradual reform strategy – proved to have its limits, so it was rather learning by doing. It was a time of experiments and many reforms were carried out in a sui generis manner. I dare say this as a veteran, serving also one year as a Prime Minister in 2000.

In time, several aspects of transition differed from one country to another: smaller countries, such as the Baltic states or Slovenia and Slovakia, opted for a fast track towards Eurozone entry, inter alia because of geopolitical and security reasons, while states with larger and more complex economies, such as Poland, Hungary, Czechia or Romania, focused their efforts more on internal development. For instance, in Poland there is talk of "Polish-ization" and "nationalisation" of development, the spotlight being on the requirement to increase the country's power resources: "if you cannot stand on your own feet, no one will listen to you". In Romania, we had a very difficult transition in the first post-communist decade, with half-hearted, gradual reform, yet after 2000 our economy has evolved more coherently, having two important anchors: the EU and NATO.

Events that were hard to foresee in the early '90s took place as well. For instance, who would have thought that Slovakia, the less developed part of Czechoslovakia, would join the euro area and Czechia would not? Under the circumstances, does euro adoption testify to a high development level? Who would have thought that Balcerowicz, the initiator of shock therapy in Poland, whose name will always be linked to its transition from a centrally-planned economy to a market economy, considered a hero of reforms in the '90s and even before the global crisis, would become now a sort of scapegoat for the less positive aspects of transition – the leader of Law and Justice Party in Poland, Jaroslaw Kaczynski, committed to " finally reject the unfortunate concepts of the pest Balcerowicz"[1] .

I don't have now the time to discuss in detail these complex processes or the differences between countries. I am sure that this conference will lay another brick to the better understanding of these processes. My intervention aims at sharing with you a few lessons that I am formulating from my present position as a central banker.

The first lesson I would like to mention refers precisely to real convergence. In almost two decades, all CEE economies have made significant progress – at various paces – in terms of real convergence, with the catching-up process benefiting substantially from their EU accession.

In Romania’s case, GDP per capita as a percentage of euro area average (based on PPS) expanded almost threefold compared to the year 2000, reaching 61 percent in 2018. Poland and Hungary stand at around 67 percent (both posting values of no more than 45 percent in 2000), Czechia at 86 percent (from 61 percent in 2000) and Bulgaria at 47 percent (against 24 percent in 2000).

As a matter of fact, Romania boasts the fastest growth rate in the group of peer countries with similar trends. Can we, therefore, say that this is proof of a successful catching-up in real terms? Furthermore, can we claim that having a flexible policy framework (including a managed floating exchange rate) helped us in this respect? Allow me to assert that more time is needed in order for these questions to be appropriately answered. However, a general remark can be made: **the EU and NATO anchors helped us all make progress as concerns real convergence**.

The second lesson derives from the answer to the following question: did the strategic decisions on the exchange rate regime and monetary policy framework matter? It is known that some countries in the region (Romania, Poland, Czechia, Hungary) opted for flexible exchange rate arrangements and adopted inflation targeting, while others (Bulgaria and the Baltic states) resorted to a fixed exchange rate regime under a currency board. At first sight, it seems that the latter group of countries are better prepared in terms of euro adoption (the Baltic states have already taken this step but they, being much smaller and more open economies, are a special case), given the fiscal discipline pursued and the nominal convergence stage in those economies. This has helped keep macroeconomic imbalances under control, yet the flipside of the coin is that the pace of real convergence was slowed by these powerful constraints, at least in the aforementioned case of Bulgaria.

Consequently, it can be said that **both approaches have benefits and drawbacks and that the story of these economies on their catching-up journey is still far from over**. I would point out that there are resources for all these economies to continue to grow relatively fast. While convergence will go on, it is unsure at what pace, how linear and how sustainable it will be, and the surprises that the future has in store for us are difficult to foresee, just like the recent past differed from what we could have forecasted two decades earlier, for instance.

The third lesson concerns the manner in which the global economic and financial crisis was weathered. With only one exception (Poland, which has not seen a single year of recession precisely because it managed to adequately combine exchange rate flexibility and fiscal discipline), all CEE economies witnessed periods of economic decline – more or less severe, shorter or longer – owing to the crisis, irrespective of their exchange rate or monetary policy regimes. The steepest decline was in Romania, which had to undergo the most painful fiscal adjustment. This occurred because the fiscal policy during the pre-crisis boom had been strongly procyclical, so that the economic advance of over 9 percent in 2008 was followed by sharp falls in the next two years: –5.5 percent in 2009 and –3.9 percent in 2010. **The lesson learned here is that there is no viable alternative to a predictable and coherent mix of economic policies and structural reforms**. Let me stress that this mix should remain in place even when facing the challenges of election years, and there are several election rounds in Romania in 2019 and 2020.

The fourth lesson could deal with the issue of whether joining the euro area ensures faster growth or not. I attended the celebrations marking the 10th anniversary of euro adoption in Slovenia and Slovakia. While in the latter country euro area membership is considered a success story, in Slovenia it is viewed as a necessary, yet painful, step. During my conversation with a Slovenian expert, I argued that the difficulties faced after euro adoption were the consequence of not cleaning up banks’ balance sheets before euro area entry. He replied that the people were not interested in these details, as what they cared about most was the standard of living, which declined after the euro changeover.

While this could be in itself regarded as a lesson, I will go further and add that the recent views expressed by policymakers in Hungary and Poland appear to favour the idea that euro area membership contains the room for growth.

A number of public statements are relevant in this respect. The Hungarian Prime Minister, Viktor Orbán, said in April 2013 that "Hungary cannot seriously consider joining the euro zone until the country's average economic development reaches 90 percent of the level of euro states". Poland's former central bank governor Marek Belka stated in 2015: "You shouldn't rush when there is still smoke coming from a house that was burning… As long as the eurozone has problems with some of its own members, don't expect us to be enthusiastic about joining". His successor at the helm of the monetary authority in Poland, Adam Glapiński, said that – and I quote – "We will not give up on the zloty (currency), because it will dramatically limit growth opportunities for the Polish economy".

Back in 2001, Leszek Balcerowicz noted that structural reforms are those that harmonise nominal and real convergence, as there are also unavoidable tensions between the two. The more comprehensive the structural reforms, the less costly the disinflation and the more robust the economic growth over the long term.

Benoît Cœuré, a member of the ECB's Executive Board, provided an overall view when pointing out, in November 2018, that the Central, Eastern and South-Eastern economies were characterised by an uneven level of convergence and that the smaller ones (from Slovenia to the Baltic states) joined the euro area irrespective of their progress in this area. Larger economies were in no hurry to adopt the euro, but rather focused in the first place on correcting some structural issues as long as the economic policy framework still enjoyed a certain flexibility.

Let me now tell you how we addressed these issues in my country. Romania chose rather to take the middle way in approaching euro adoption, envisaging a real convergence level of at least 70–75 percent prior to entering the euro area, as a lower level would cause us to be severely affected by asymmetric shocks and therefore be unable to synchronise our business cycle with that of other euro area economies. As for the Maastricht criteria, from July 2015 to November 2017, Romania fulfilled all the convergence criteria in the Treaty (yet without participating in the Exchange Rate Mechanism). The fact that, at this moment, the reference values for the long-term interest rate and inflation are no longer complied with is a warning that efforts should be undertaken to attain nominal convergence in a lasting manner, not accidentally or temporarily. This is feasible only when the two types of convergence reinforce each other.

The inherent flexibility of a managed float regime such as the one pursued by the NBR does, however, have its clear limitations, which should not be overlooked – this does not imply, by any means, that the central bank acts in a discretionary manner, taking the exchange rate wherever it wants. The abuse of flexibility can be as harmful to the proper functioning of the economy as the abuse of rigidity. In fact, the inflation-targeting regime implemented by the NBR is a mix of rules and discretion with the aim of formulating a coherent and effective monetary policy.

As regards the current differences in the countries' approaches to euro adoption, for some it might seem odd that Bulgaria, which lags behind in terms of real convergence, is considering joining the euro area sooner than Romania. It is only natural for our neighbour to contemplate euro adoption as the only sound exit from the present currency board. By contrast, in Romania, as well as in other countries pursuing a floating exchange rate regime, the approach is different, since euro adoption is more complex. This is by no means to say that Romania does not envisage joining the euro area, but merely that a comprehensive preparation is of the essence to cope with the related challenges.

The Latin dictum *festina lente* is, in my opinion, quite suitable in the case of euro adoption as well. With respect to real convergence, many have been asking themselves "How fast is fast enough?". Unlike others, I would not necessarily look for a certain figure (beyond the already mentioned minimum level of roughly 70–75 percent); **I would tackle this issue by approaching real convergence not as a race where the fastest track is also the right one, but rather as a complex process giving the steady runner (a marathoner rather than a sprinter) the opportunity to reap most of the potential benefits, while avoiding excessive risks**.

Speaking about risks, it is worth noting that relatively sizeable current account and fiscal deficits may erode the very foundation of this edifice that is the national economy. It is therefore much wiser to adjust them in a gradual manner than leave market forces to cause a sudden correction.

Fiscal discipline, consistent economic policies and an ambitious, yet viable, calendar should make a successful euro adoption possible, so that the economy adequately withstand competitive pressures within the euro area. Equally important is to reduce the still overly large disparities across Romania's development regions, as it takes the entire country to join the euro area, not only Bucharest and Ilfov county. **Economic growth is not enough, it should be accompanied by lasting economic development**.

Before ending my speech, instead of my personal view about the future, let me quote a recent column in *Financial Times* by Tony Barber[2] relevant for the state of affairs in the region: "Nevertheless all is not well in the region. Why? One reason lies in the model that western governments in the 1990s prescribed for the east's transition to free-market democracy. As it shed its communist past, the east was told to embrace not just liberal democracy but globalisation, open borders and the lightly regulated financial capitalism that the west viewed as the touchstone of its own economic success.

This model's flaws were exposed in the 2008 financial crisis and the European refugee and migrant emergency of 2015–16. […]

EU membership, too, has brought more pluses than minuses. Access to the single market, regional aid and, from ordinary people's viewpoint, Europe-wide freedom of movement are cherished gains. […]

This resentment has much to do with the western model grafted on to the east. In 1989, as during Europe's 1848 revolutions, the people wanted civic freedoms and, in many cases, liberation from foreign overlords and their first independent states of modern times. But after 1989 the adoption of the western model — complete with EU membership, global capitalism and a liberal political philosophy — created tensions between liberalism allied to internationalism and the assertion of a newly acquired national sovereignty. […]

Now central and eastern Europe is experiencing its own contest between populist nationalism and liberal democracy. It would be brave to forecast a winner when some western societies are caught up in much the same struggle."

This being said, let me thank you for your attention and wish you insightful discussions.

---

[1] "Poland's wild ride out of communism remains election faultline", James Shotter, Financial Times, 2 October 2019.

[2] "The legacy of 1989 has been complacency", Tony Barber, Financial Times, 2 October 2019.