

The 39th Meeting of the Central Banks Governors' Club of the Central Asia, Black Sea region and Balkan countries

Governor Mugur Isărescu's address in

Session I: Global Economic Outlook and Financial Conditions

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Dear colleagues,

Let me start by saying that I am honoured to have been invited to speak here, in beautiful Bodrum, at the 39th Meeting of the Central Banks Governors' Club of the Central Asia, Black Sea Region and Balkan Countries. Our club includes central banks from EU countries, some already in the Eurozone, while others belong to countries outside the EU. Some of the members in our group come from countries that have enormous economic potential and belong to G20, which has become an essential part of the architecture that has fostered international debate on financial and economic issues after the crisis. This is why our club reflects quite interestingly the constellation of political and economic interests that defines our world.

This meeting comes at a time when the international landscape is dominated by an overall positive mood, on the economic front at least, even though, recently, a number of downside risks have become more apparent. In the European Union, economic growth reached in 2017 its post-crisis peak, with most Member States witnessing higher GDP dynamics. At the same time, unemployment continued on a downward path and economic sentiment improved across the board. Some recent signals point to a slowdown, yet they seem to have more to do with temporary influences, growth prospects continuing to look strong. The past year recorded, on average, positive developments in EU candidate and potential candidate countries as well, in spite of GDP dynamics delivering a more mixed picture (from over 7 percent in Turkey to around 2 percent in Serbia and even stagnation in the Former Yugoslav Republic of Macedonia). Nevertheless, the outlook is positive, with recent forecasts pointing to relatively robust growth in the coming years.

However, against this relatively rosy background, I should highlight that our economies, even those that belong to the Eurozone, have still much to do in order to become robust and offer good living standards to most of their citizens. Some members of this Club, Romania included, had to go through very painful adjustments during the past decade, as the global crisis found them trapped in a pro-cyclical policy stance and it remains to be seen to what extent they will manage to break free from this pattern in the current good times; some need to fight high inflation, pressures on their currencies or to correct their external imbalances. Nevertheless, the common denominator of all our economies is having to deal with institutional weaknesses and the need to undertake reforms that should make them stronger.

A common challenge our emerging economies are facing is the need to speed up convergence towards the development level of mature economies. In order to achieve this, the responsible policymaker should be concerned with steady progress and not with delivering bouts of accelerated growth, which may turn out to be reversible. This brings us to the need to address bottlenecks to potential growth – even though in Central and Eastern Europe, for instance, growth is now much stronger than in the euro area, most countries have still work to do in order to ensure that potential growth matches the catching-up needs. At least in the non-euro EU members in Eastern Europe, bottlenecks to sustainable growth usually stem from structural impediments to labour supply (high emigration, low participation rate, decline in working age population, skill mismatch), inefficiencies in public administration, quality of institutions, in general, and in some cases, inadequate infrastructure.

While inflation has reemerged in Central, Eastern and South-Eastern European countries, in most cases it remains tepid (broadly, around 2 percent). Nevertheless, it has spiked in such cases as Romania and Turkey, where it currently stands at 5 percent and 11 percent respectively. Part of this reemergence is related to the global cycle, as it comes from international commodity prices, with idiosyncratic supply-side factors and domestic demand pressures accounting for the rest of the explanation. These latter two sources are particularly relevant in Romania, where changes in indirect taxation and regulated utility prices have played a significant role in the recent inflationary spell, adding to the underlying inflationary pressures stemming from the opening of the positive output gap (to which contributed a persistently expansionary fiscal policy), increases in wage costs, and, last but not least, an upward adjustment in inflation expectations.

As a matter of fact, significant acceleration in wage growth is a common feature of the non-euro EU member group. Nevertheless, in most cases this has not led to a deterioration in the current account positions, which remained in surplus. Unfortunately, Romania appears as an outlier within the group: while its current deficit is well below pre-crisis levels, it widened rapidly from a minimum of 0.7 percent in 2014 to 3.4 percent in 2017, which puts Romania closer to the group of EU candidate countries (around 5.5 percent in Serbia and Turkey).

Against such a background, it is no wonder that – while the monetary stance remains largely accommodative –, the picture is quite heterogeneous regarding inflation expectations, inflation targets, and policy tools used.

Romania has already started the tightening of monetary policy by hiking the rate three times this year, after further narrowing the corridor around the policy rate last year, but going forward we believe a gradual approach is warranted. And this brings us to the issue of monetary policy normalisation. What I believe most people understand by this concept is a return to the standard operating mode of monetary policy, i.e. the withdrawal of the unconventional policy tools deployed during the crisis, which would entail a gradual increase in short-term interest rates and a gradual unwinding of bloated central bank balance sheets. The latter is by far the most challenging process, as the impact on global asset prices is a delicate issue, which not only requires good planning and favorable macroeconomic conditions, but is also bound to be lengthy.

As regards the other element of policy normalisation – the increase in short-term interest rates –, while less controversial, it is by no means problem-free, considering its implications for financial stability. To quote the BIS Annual Report 2017, “policy normalisation presents unprecedented challenges, given the current high debt levels and unusual uncertainty”.

The increase in short-term interest rates is an element of normalisation that also applies to the central banks that did not step out of the conventional framework – and this is the case in most Central, Eastern and South-Eastern European countries. Personally, I see normalisation as amounting ultimately to a return to real positive interest rates. I doubt, however, that this will be a swift process. In the case of Romania, the steps taken so far along the road to policy normalisation, were facilitated by two favourable developments in the banking sector.

First, the NPL ratio dropped from above 20 percent at end-2014 to almost 6 percent presently, making it the largest adjustment in the EU over a relatively short time period. At the core of this adjustment were conservative requirements for provisioning NPLs, our hands-on supervisory approach, and a fiscal facility that was conducive to the development of the secondary market for NPLs. Second, the share of leu-denominated loans in the total stock of loans has increased from one third prior to the crisis to two thirds nowadays, with the benefit of reducing contagion risk and improving the transmission mechanism of the monetary policy.

However, it would be risky to press ahead too fast. In the case of the ECB, while the tapering of its QE has already started, an upward move in the interest rate is not likely to happen soon. As for peer countries such as Poland and Hungary, their macroeconomic conditions do not seem to warrant a start of the tightening cycle this year either, with still below-target inflation. As long as real interest rates remain negative all over Europe, straying too far away from our regional peers in terms of policy rate would invite disproportionate appreciation pressures, which – while helpful in terms of inflation – would not be a welcome development, given Romania's increasingly negative external imbalance.

Therefore, striking the right balance in terms of the interest rate differential is of the essence – after the substantial tightening undertaken so far, translating into money market rates increases by almost 200 bps (a normal development given the size of the inflation differential), it is probably wise to proceed more cautiously from now on. As such, the future action of the NBR is likely to depend on how the process of monetary policy normalisation will be unfolding in Europe.

Policy normalisation is a question of “when”, not “if”. It will eventually gain momentum and the impact of major central banks’ policy reversals on emerging economies should not be underestimated. When the tide eventually hits, the extent of the damage depends on how vulnerable emerging economies are to external financing. A contained current account deficit, a long average maturity on public and private foreign currency debt and a proper policy mix will help limit the negative externalities.

Summing up, keeping internal and external imbalances in check is the only way our economies will be able to cope with the strong volatility headwinds ahead of us. Indeed, it would be a shame if the necessary reforms were not undertaken now, while there is a window of opportunity.