MUGUR ISARESCU

Governor of the National Bank of Romania, Former Romanian Prime Minister

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Mr Isarescu has a role that is probably even more difficult than being the leader of the European Central Bank, because the political environment is even more unstable in Romania. However, you have always been stable; the currency has always followed more or less a stable path. What do you think of the leadership of the politicians and your leadership of the Central Bank? Could you actually survive in an environment that has been politically very unstable?

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My opinion is that political leadership is essential. Since they are elected, politicians enjoy democratic legitimacy. In hard times, but for limited periods, technocrats could step in and I have been in such a situation myself. I was Prime Minister for a year and returned to the central bank of Romania afterwards and the experience made me realize, once again, that political life is tougher than central banking. Certainly, the best thing a central bank can do for the government is to fulfil its mandate of maintaining price stability, but, when necessary, it can also provide expertise and professionals, and the National Bank of Romania did that several times in the past.

One lesson I learned from my experience was understanding that the independence of the central bank should not lead to isolation, but should rather be seen as active independence. It involves working together with the government while sticking to your mandate, pursuing the objectives set by law, but supporting the government with all the skills you have developed over time. I would say it also involves understanding that political life is not simple at all. Sooner or later you have to come to terms with the fact that politicians face public scrutiny, are required to accommodate people's needs and, ultimately, are the ones who had to fix the crisis fallout. Central bankers also have a share in this effort, but from my point of view it is crucial they have some kind of understanding of the constraints politicians are faced with.

Secondly, we understood from the very beginning that the mandate of maintaining price stability was only a part of our job. Given the specific features of economic and political developments in the country, the National Bank of Romania has always had to strike a balance between the three aspects of stability (if I may quote Charles Goodhart) – price stability, financial stability and external (currency) stability. The National Bank of Romania never had the luxury of being concerned only with price stability and interest rate setting, in the belief that financial stability and exchange rate stability will follow.

From the start the NBR took on an additional task, which was the transformation of the Romanian banking system from a mono-bank to a two-tier banking system; and after this, to privatise the banks, to bring foreign capital, know-how and modern practices into Romania's financial sector. The transformation process the banking system had to go through has been accompanied by rather frequent financial instability episodes, especially after the full capital account liberalisation. The massive capital inflows that followed have limited considerably the room for manoeuvre in using the policy rate to manage the aggregate demand. That period taught us how difficult it is to use the policy rate in order to deliver price stability and financial stability at the same time.

The third lesson is to avoid applying monetary theory in a mechanical manner. To be more specific, by considering the country-specific circumstances, we gradually developed what we called, before the crisis broke out, an unorthodox monetary policy. Some of the instruments we employed back then are now part of the macroprudential toolkit in use in several countries around the world. I discussed with Marek Belka several times, when he was an IMF director, that currency stability and external stability proved to be highly sensitive issues in a country like Romania. The exchange rate is perceived by the general public as more indicative for the state of the economy than the interest rate; depreciation is interpreted as signalling that the country is not moving in the right direction. Moreover, exchange rate appreciation would lead to the undesired effect of stimulating forex credit.

We also tried to look at exchange rate stability in a kind of a sliding corridor, as I learned in the 1990s when Jacob Frenkel was Governor of the Bank of Israel. It is not at all simple to have only one instrument, namely the policy rate, to deal with all these aspects. As a result, we had to deploy alternative instruments such as reserve requirements and prudential measures, when necessary. I will also mention that Jean-Claude Trichet understood me in 2006 when I tried to explain that increasing interest rates to slow down inflation, which was higher in Romania that in Europe, was not the best instrument, because this was stimulating forex credit, and inflation was not increasing because of local currency credit, but because of forex credit. This was a by-product I did not realize how poisonous it was when the state-owned banks were privatised.

Being a small open economy and part of the European Union, we had to use different instruments and we could not be dogmatic. We were able to maintain price stability and financial stability and none of the banks needed to be rescued on taxpayers' money.