Ladies and gentlemen,

The two keynote speakers shared with us insightful thoughts about the consequences of monetary policy and financial shocks and about the responses of CEE countries.

My intervention will be structured around three issues. First, I will refer to the impact on emerging economies in the EU expected to be exerted by monetary policy normalisation in the euro area. Second, I will tackle the subject of how inflation targeting has adapted to the post-crisis global economic and financial landscape. Finally, the topic of what the CEE economies need to do in order to cope with any strong volatility headwinds will be touched upon.

There is no doubt that the recovery of the EU economy in the past years was largely due to major central banks' non-standard operations, as well as to very low interest rates. We all know that the reversal of this process also has substantial implications for the economic development, mainly through the influence of monetary policy normalisation on financing conditions or capital inflows.

Irrespective of the uncertainties currently surrounding the timing and pace of policy normalisation in the euro area, it will eventually gain momentum and the impact on the emerging EU economies, to which I will come back later, should not be underestimated. It is debatable if the forthcoming normalisation process involves going back to the pre-crisis normal or rather moving forward to a "new normal", characterised by lower interest rates and possibly by larger central bank balance sheets.

What is certain is that future policy actions of central banks in CEE countries will definitely depend on the way monetary policy normalisation unfolds in Europe. What happened in the emerging economies that are part of the US dollar sphere of influence following the FED's policy normalisation is quite relevant. Higher interest rates in the developed world would trigger a capital flight away from emerging economies, thus generating depreciation pressures. The response of policymakers in emerging economies will depend on the specific strengths and weaknesses. Where adequate policy buffers are in place and investor confidence is elevated, market mechanisms, countercyclical macroeconomic and prudential policies may be relied upon to tackle a slowdown in capital inflows. Where there is less room for manoeuvre, tightening monetary and fiscal policies may be required to lower financing needs and attract additional inflows. Where foreign reserves are adequate, they may be used to moderate or smoothen exchange rate depreciation.

Let me now move on to the second point of my intervention: how inflation targeting has evolved in response to the post-crisis global economic and financial environment. The NBR, the same as the central banks of Poland, Czech Republic and Hungary, is an inflation targeter. In Romania, we have remained loyal to inflation targeting since 2005, but inflation targeting itself is quite different now from 15 years ago.

Indeed, it is rather difficult to say at present what is left of its underlying principles. The outbreak of the global crisis and the post-crisis developments have naturally led to the tailoring of the strategy to the new realities. Some departures from the old orthodoxy are almost unavoidable in the present context, marked by a changing global financial and economic landscape. For instance, after the crisis, forex interventions re-entered the arsenal of many central banks, including some of the previously more purist floaters. A case in point is the Czech National Bank, which resorted to the so-called “exchange rate commitment” from November 2013 to April 2017, intervening whenever necessary without time or volume limits to prevent the appreciation of the koruna below a publicly announced floor.

I find relevant what Agustín Carstens, General Manager of the BIS, said in his lecture held at the London School of Economics in May 2019: “The textbook version of the inflation targeting framework, which prescribes pursuing inflation stability with floating exchange rates through adjustments of a short-term interest rate, is obviously too narrow for EME central banks. In particular, the financial channel of the exchange rate gives rise to difficult trade-offs for monetary policy, while at the same time complicating the conduct of monetary policy by weakening its transmission. EME central banks have risen to this challenge through their innovative use of additional policy instruments. They have turned to FX intervention to deal directly with the financial channel or insure against undesired exchange rate swings, and to other non-orthodox balance sheet policies as well as macroprudential tools to deal with specific imbalances or vulnerabilities in a targeted way.” Not only that I share his view, but I have to say that, in Romania, we started practicing what he speaks about now even before the outbreak of the global crisis. We resorted to forex interventions in order to mitigate the exchange rate volatility and we took prudential measures to contain excessive growth of credit (of forex lending in particular). The IMF mentioned the NBR as being among "the pioneers" of what was later referred to as "macroprudential instruments".

As a matter of fact, back in 2005, being aware of the risks associated with the free capital movement and subsequent ample fluctuations of the exchange rate, the National Bank of Romania decided to adopt a "light" version of inflation targeting. We deemed it more suitable than any other option in terms of sustainably achieving price stability, while limiting the cost of excessive volatility in output and employment. In fact, the NBR’s overall approach has been a balanced one. On one hand, we did not ignore the threat of inflation for the sake of fast and easily gained (and therefore unreal) prosperity. On the other hand, we tried to avoid becoming, in Mervyn King's words, an "inflation nutter".

Let me emphasise that the classic recipe of inflation targeting would recommend a policy rate hike at the current juncture in some of the CEE countries. However, in Poland, Czech Republic, Hungary and Romania, policy rates currently stand below the inflation rate. And precisely because 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.

But beyond the regional environment, if we look at advanced economies and, in general, at the euro area, we see low inflation and modest economic growth rates prevailing. They do not necessarily call for a tightening of monetary policy. By contrast, CEE countries have rather high inflation and significant economic growth rates, therefore the context would be described in a textbook as adequate for tightening. Yet, in the case of these countries, there is a real risk posed by speculative capital inflows.

As long as negative real interest rates prevail in Europe, straying too far away from our regional peers in terms of policy rate would invite considerable appreciation pressures. While helpful in terms of taming inflation, these would not be welcome, given Romania's increasingly significant external imbalance that 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 manifest in certain production sectors. Therefore, striking the right balance in terms of the interest rate differential is of the essence. After the tightening undertaken so far in Romania (including three policy rate hikes in the first half of 2018), it is probably wise to proceed cautiously in the future.

Which brings me to the last issue I would like to address: what is advisable in terms of economic policies in order to cope with any future adverse developments. For the sake of simplicity, allow me to try to formulate three general rules that are instrumental in dealing with such developments.

First of all, irrespective of the possible scenarios, it is wise to put your house in order before the storm comes. One example is fiscal consolidation, which is paramount for the economy. Relatively high fiscal and current account deficits may weaken the foundation of the building and adjusting them in a smooth manner is a much more sensible thing to do than letting the market forces make an abrupt correction. As regards monetary policy, strict liquidity management represents a step in the right direction.

But, of course, monetary policy alone is not enough. Which brings us to the second rule: there is no substitute for a predictable and coherent economic policy mix. Let me stress that it should remain so even when facing the challenges of election years (there are several election rounds in Romania in 2019 and 2020). A significant pace of economic convergence is desired, but the process should unfold sustainably to preserve macroeconomic equilibria and safeguard competitiveness. As I usually put it, to successfully adopt the euro, one should be a *marathoner* rather than a *sprinter.*

Last, but not least, the third rule might be as follows: when the normalisation wave eventually hits, the magnitude of the impact will depend 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 coherent mix of countercyclical macroeconomic policies and structural reforms would go a long way in limiting the risks. If proper economic policy actions are not implemented while there is a window of opportunity, the possibility of a forced resort, in a more or less distant future, to sub-optimal measures in the face of adversity cannot be ruled out.

To sum up, keeping domestic and external imbalances in check is the only way the CEE economies will be able to cope with any strong volatility headwinds.