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Since the early 1990s, when the Reserve Bank of New Zealand instituted inflation targeting (IT) as its monetary policy framework, IT gained reputation, becoming the monetary regime of choice of many central banks around the world. Among them, the National Bank of Romania changed in mid-2005 the strategy of the monetary policy with IT. As a member of the European Union, Romania’s ultimate aspiration is the adoption of the euro as a means to achieve its objective of full participation in the European Monetary Union. In order to accomplish that, among other nominal and real convergence criteria, Romania must spend at least two years in the ERM II, keeping its exchange rate towards the euro stable, inside a band of ±15%.

The purpose of this paper is to identify the challenges of direct IT implementation in Romania in the current context with the perspective of joining the ERM II. We will find out that IT, as current monetary policy strategy, is to be maintained at least until the ERM II entry. After that, the NBR’s focus will shift back from price stability to exchange rate stability, and thus, a strict IT framework will not be appropriate anymore (the co-existence of IT with an explicit exchange rate objective being quite problematic). The paper concludes that a soft version of inflation-targeting is more appropriate under the given circumstances.

1. Introduction

For a central bank, getting the monetary policy right is crucial to the health of the economy. If the bank promotes an overly expansionary monetary policy these will lead to high inflation, which decreases the efficiency of the economy and hampers economic growth. Romania has not been exempt from inflationary episodes (especially in the ‘90s), but more extreme cases of inflation, in which the inflation rate climbs to over 100% per year, have been prevalent in some regions of the world such as Latin America, and have been very harmful to the economy. On the other hand, a monetary policy that is too tight can produce serious recessions in which output falls and unemployment rises. It can also lead to deflation, a fall in the price level. Deflation can be especially damaging to the economy, because it promotes financial instability and can even help trigger financial crises. Mishkin (2004) illustrates important episodes of deflation that occurred in the United States during the Great Depression and in Japan more recently.

Considering the above, to get that monetary policy right in order to achieve its primary objective (like Romania, in most western industrialized countries the primary objective of monetary policy is the maintenance of price stability) the National Bank of Romania (NBR) has a set of monetary policy instruments at its disposal. The NBR does not control the prices directly by using these instruments but through a complex transmission process, which describes the stages with which a change in money supply/short-term interest rates leads to changes in the economy’s price level (Friedman, 1975). According to Belke and Pollet (2009: 667) the transmission process is typically subject to variable and not fully predictable time lags.

* Ph.D. Student, Faculty of Economics and Business Administration, “Alexandru Ioan Cuza” University of Iași, Iași, Romania
In fact, it can be expected to be continuously changing in response to changes in economic behavior and institutional structures. Another important aspect to be taken into consideration is the environment in which policy makers take their decisions. Thereby there is a need for an organizing analytical framework, which would help to order, analyze and interpret monetary policy relevant data and present and announce policy decisions made to the outside world. This is actually the role of a central bank’s monetary policy strategy (ECB, 1999: 43): “A monetary policy strategy is a coherent and structured description of how monetary policy decisions will be made in the light of the behavior of economic indicators, in order to achieve the overriding objective of price stability”.

In theory as in practice there was (and still is, in the light of the current financial crisis) an ongoing debate concerning the optimal monetary policy strategy. As we look into the past decades we draw a line and conclude that inflation targeting (IT) eventually emerged as the preferred solution to the complex economical, political and social issues regarding present times. After being adopted for the first time by New Zealand in 1989, many industrial countries and emerging markets alike shifted their own monetary regime towards IT. At the start of 2010, a number of 27 central banks (Hammond, 2010) were considered fully fledged inflation targets, and many others were in the process of establishing a full inflation-targeting. Among them, several other central banks like the European Central Bank (ECB), the Swiss National Bank or the Federal Reserve of the United States, have moved towards regimes that have many of the attributes of IT.

In Romania the NBR introduced IT as a monetary policy strategy in 2005. This regime was taken into consideration because it brings a series of benefits for a central bank, including a clear policy focus on inflation. More than that, in the context of a disinflation process in which Romania is engaged since 2000, IT came as a mean to unburden NBR’s monetary policy to achieve further descending inflation rates.

Starting on January 1st, 2007 Romania became a Member State of the European Union. In order to achieve its objective of full participation in the European Monetary Union (the adoption of the euro) it must set its monetary institutions and policy in line with the euro area; in other words, a set of nominal and real convergence criteria must be achieved. A criterion implies that Romania must spend at least two years in the Exchange Rate Mechanism (ERM II), keeping its exchange rate towards the euro stable, inside a band of ±15%. What does this mean for the NBR? It must find the proper instruments to assure a smooth transition from its current exchange rate regime to the irrevocable fixity of exchange rate against other Euro Area currencies. That is why NBR’s attention will shift back from price stability to the exchange rate anchor, implying that the current form of IT will be maintained at least until the ERM II.

The article is organized as follows. The first part of the paper consists in a survey of the literature regarding IT as a monetary policy strategy. In Part 2, after a brief presentation of key features of IT frameworks in the most important central banks around the world, the paper examines the current status of IT in Romania. Part 3 analyzes the current position of Romania in its way to the EMU. Part 4 of the paper presents possible mutations that might appear in the current IT strategy in the view of the ERM II entry. Conclusions highlight the most important aspects of the paper and some lessons to be learned.

2. Financial literature regarding IT as a monetary policy strategy

Much of the existing financial literature as well as the experience of policy makers lead towards the idea that IT is the new orthodoxy of mainstream macroeconomic thought. In present times we find ourselves in front of a vast amount of literature on IT where different authors have proposed different, and in some cases conflicting but solid, definitions.

In broad terms, according to Setterfield (2006: 653) the IT policy framework involves “the public announcement of inflation targets, coupled with a credible and accountable commitment on the part of government policy authorities to the achievement of these targets”. To other authors (Allsopp, 2009) IT normally involves delegation of responsibility for medium term control over inflation to an independent central bank using interest rates as its primary instrument to influence inflationary pressure.

According to Daianu and Kallai (2008: 64) there is a broad and a narrow approach for the IT definition. Regarding the broadest definition of IT, it is a “monetary policy framework that accords overriding importance to the maintenance of price stability”. In what concerns the narrower definition, IT is a “monetary policy framework based on the adoption of a monetary policy rule in which forecasts of future inflation play a central role, either in the form of instrument rules or of target rules”. They refer to an instrument rule as a monetary policy instrument which can be characterized as a simple and usually linear function of deviation of a few key macroeconomic variables from their target level. Referring to the target rule it expresses the monetary policy instrument as the solution to an optimization problem defined by a loss function describing the costs associated with deviations of specific goal variables from their target levels subject to the constraints imposed by the model of the economy’s structure.

Many practitioners simply adopt the widely cited definition of Alan Greenspan, the former Governor of the US Fed, issued at the July 1996 meeting of the Federal Open Market Committee, as “a rate of inflation that is sufficiently low that households and businesses do not have to take it into account in making every day decisions” (Epstein & Yeldan, 2009: 3).
Although the literature and practice of IT is anything but uniform across various countries, a number of common elements of central banks’ IT policies (Bernanke et al., 1999; Dotsey, 2006; Neumann & von Hagen, 2002) can be drawn: 1) an emphasis on long-run price stability as the principal goal of monetary policy; 2) an explicit quantitative target for inflation and a timetable for reaching that specific target; 3) a high degree of transparency with regard to monetary policy formulation; 4) central bank accountability for performance in achieving the inflation objective; 5) a policy approach based on a forward-looking assessment of inflation pressures, taking into account a wide array of information.

All these elements conduct towards the idea that central banks cannot consistently pursue and achieve multiple goals, such as low inflation and low unemployment, with only one basic instrument, the policy interest rate. Another important aspect is that (Roger, 2010) over the long term “monetary policy can influence nominal but not real (inflation-adjusted) variables, high inflation harms growth and the equitable distribution of income, and expectations and credibility significantly influence the effectiveness of monetary policy”.

Although there is sufficient evidence that prove a good performance of IT in many quite different kinds of economies, some questions rise about the economic and institutional factors that lead countries to adopt and sustain IT. One issue concerns the conditions needed to begin inflation targeting. There are authors (e.g., Mishkin & Schmidt-Hebbel, 2002) that point toward the role of initial institutional and economic conditions satisfied when adopting and maintaining IT adoption. In contrast, others like Laxon and Batini (2007) show that initial conditions do not matter for adopting IT. In their point of view most countries build up gradually, after starting IT, better macroeconomic conditions and institutional features of full-fledged IT.

Reviewing the literature a range of “technical” conditions to support efficient and effective implementation of IT can be mentioned (Roger, 2009): 1) institutional arrangements, including legislation or public commitments, providing clear prioritization and specification of the policy target, and giving the central bank with necessary autonomy to pursue the objective; 2) analytical capabilities and data availability to conduct a forward-looking assessment of inflation pressures and the appropriate policy response; 3) an economic structure that promotes transmission from the policy instruments to inflation outcomes; 4) a sound financial system conducive to effective policy transmission, and avoidance of conflicts between the policy objective and maintenance of financial stability.

As a strategy for the conduct of monetary policy IT has several advantages (Mishkin, 2004): 1) IT enables monetary policy to focus on domestic considerations; 2) stability in the relationship between money and inflation is not critical to its success; 3) it is readily understood by the public and is highly transparent; 4) it increases accountability of the central bank; and 5) it appears to ameliorate the effects of inflationary shocks. A major advantage is that IT combines elements of both “rules” and “discretion” in monetary policy, and is therefore often characterised as “constrained discretion”. King (2005: 13) noted that “An inflation-targeting framework combines two distinct elements: (a) a precise numerical target for inflation in the medium term and (b) a response to economic shocks in the short term. The inflation target provides a rule-like framework on which the private sector can anchor its expectations about future inflation”. Within this rule-like framework, the central bank has discretion in reacting to shocks, for example in how quickly to bring inflation back to target. However it does have some disadvantages too: 1) inflation is not easily controlled by the monetary authorities, so that an IT is unable to send immediate signals to both the public and markets; 2) it might impose a rigid rule on policymakers, although this has not been the case in practice; and 3) a sole focus on inflation may lead to larger output fluctuations, although this has also not been the case in practice.

After this brief presentation of the existing financial literature and practice an obvious question may arise, and that is, whether macroeconomic performance under IT has been as good as or better than under alternative policy approaches, such as targeting money growth, exchange rate pegs, or “eclectic” frameworks with multiple objectives. Levin et al. (2004) investigate the experience of inflation-targeters and non-inflation-targeters since 1994 in a number of OECD countries and emerging countries. They conclude that: 1) inflation is more persistent for non-IT economies especially when the focus is on core inflation and not CPI; 2) GDP growth volatility is the same for IT and non-IT economies, but inflation volatility is higher for inflation targeters.

Another study was conducted by Roger (2010). Since it is not possible to compare directly one country’s performance under two different policy regimes over the same period, Roger made comparisons between similar countries with different approaches: IT countries and non-IT countries.

In the next figures Roger compares inflation and output performance in IT countries before and after they adopted IT with non-IT countries over the same period. For IT countries, the median IT adoption date, according to Figure 3, was the beginning of 2001, so the comparison periods for non-IT countries are set at 1991-2000 and 2001-2009. According to Figure 1, inflation and growth rates improved in most countries between the periods taken into account, but slightly better rates were registered in IT countries.

In Figure 2, we can notice that swings in both inflation and growth were less volatile in the period 2001-2009 than in 1991-2000, but the decline was greater in IT countries.
We can conclude that: 1) regarding IT and non-IT low-income-economies, both groups of countries experienced major reductions in inflation rates and in the volatility of inflation and output and considering improvements in average growth rates, but better performances were registered by the inflation targeters; 2) regarding the high-income-economies, IT countries showed little change in performance, on average, between the two periods, whereas the non-IT countries typically experienced a decline in growth. Moreover, IT countries saw little change in output or inflation volatility between the two periods, but the non-IT countries experienced greater output volatility. An important aspect needed to be taken into consideration is that the adoption of IT as the MP strategy may not fully explain the improvement in relative performance (inflation and growth rates), since many countries adopting IT did so as part of broader structural and policy reforms.

3. IT in Romania and other central banks – current status

3.1. The IT frameworks of central banks around the world (some key features)

After the failure of money targeting in the mid-1980’s and the collapse of fixed exchange-rate-peggs in the early 1990’s a new monetary policy framework was needed. In this context inflation targeting with floating exchange rates emerged as the new monetary regime of choice.

According to the Bank of England report from January 2010 (Hammond, 2010), at this moment there is a number of 27 central banks considered fully fledged inflation targeters, and many others in the process of establishing a full IT. Figure 3 shows the dates of formal adoption of IT for the countries above at the start of 2009, and the inflation rate at adoption.

The spread of inflation targeting has often been spurred by exchange rate crises. Figure 4 shows exchange rate pegs of various kinds accounted for two-thirds of monetary policy regimes in industrial countries in 1989. Among the crises the most important is considered to be the ERM crisis in 1992 which served as a major spur to the adoption of IT in Europe (as we have seen in Figure 3).

The next part briefly reviews some key features of the monetary policy strategy of four most important banks in the world: the European Central Bank (ECB), the Federal Reserve System (Fed), the People's Bank of China (PBC) and the Bank of England (BoE).

The ECB uses a hybrid monetary policy strategy that has much in common with the monetary targeting strategy previously used by the Bundesbank but also has some elements of IT. The ECB's strategy is based on two key “pillars”: the first is a prominent role for monetary aggregates with a “reference value” for the growth rate of a monetary aggregate (M3) and the second one is a broadly based assessment of the outlook for future price developments with a goal of price stability defined as a year-on-year increase in the consumer price index below 2% (Mishkin, 2004).

The Fed has a strategy of having an implicit, not an explicit, nominal anchor in the form of an overriding concern to control inflation in the long run. In addition, it involves forward-looking behavior in which there is careful monitoring for signs of future inflation using a wide range of information, coupled with periodic “pre-
emptive strikes” by monetary policy against the threat of inflation.

In December 1993, as the PBC established that the goals of monetary policy were to maintain the stability of the value of the currency, promoting economic growth, the monetary policy considered low inflation as being conducive to these objectives. In 1996 the PBC announced M1 and M2 growth rates as the official intermediate targets of China’s monetary policy. Nowadays monetary base targeting and the usage of M1 and M2 as the intermediate targets for the bank’s monetary policy is commonly accepted (Geiger, 2008).

Since the government granted the BoE operational autonomy on May 1997, the Chancellor would set a target inflation rate and the Bank would implement this with an independently chosen interest rate. At the
moment the IT of 2% is expressed in terms of an annual rate of inflation based on the CPI. The remit is not to achieve the lowest possible inflation rate, a target below 2% being judged just as bad as inflation above the target. The inflation target is therefore symmetrical (BoE, 2010).

As we can see there are some central banks that in spite of not having a fully fledged IT strategy they have moved towards regimes that have many of the attributes of IT.

3.2. The IT framework in Romania

In most countries adopting IT as a monetary policy regime, there has been an initial phase of disinflation. Romania is not an exception. The disinflation process has been pursued successfully in Romania in this decade. The inflation rate came down from over 40% in 2001 to 4.9% (Dec. on Dec.) in 2006. In 2007, when Romania joined the EU, inflation went up again (above 6.5%) owing to adverse internal and external shocks. Nowadays, in the context of the current financial crisis, despite the sharp downturn, inflation has remained relatively high by regional standards. End-2009 CPI inflation was 4.7%, down from 6.3% in 2008.

In the period 1997-2004, Romania followed an eclectic monetary-base-targeting framework, with increased reliance on interest rates and relatively frequent interventions within a managed float regime (Popa, 2008). The NBR shifted to direct IT in August 2005 in order to strengthen disinflation and bolster the central bank’s credibility. This monetary policy strategy was adopted after completing a preparatory process, whose last stage was to set up and test the functioning of the economic analysis and monetary policy decision framework specific to IT (Popa, 2005). NBR received technical assistance from the IMF and the Czech National Bank in the process of implementing the new monetary policy strategy. The adjustment phase including the efforts to set up the organizational and technical framework spanned about 16 months.

NBR’s adoption of IT was judged as a means to bring major benefits for Romanian monetary policy. Daianu and Kallai highlighted three main benefits by adopting IT. “First of all, by enlarging the projection period in which an inflation target is pursued, the central bank would escape from the trap of time inconsistency. Second, by adopting a single publicly acknowledged goal, such as an inflation target pursued over the medium term, the central bank could manage inflation expectations so that the required short-run deviation from the target does not jeopardize the final goal. Third, the central bank might benefit from a kind of demonstration effect by using a method adopted in some of the EU’s newest members” (Daianu & Kallai, 2008: 67).

Governor Mugur Isarescu (Isarescu, 2008) stated that there are three main reasons for adopting the IT strategy:

- a decreasing efficiency of the monetary targeting strategy (because the unstable relationship between the monetary aggregates and inflation);
- the negative influence which may have had the capital account liberalization on the exchange-rate-targeting strategy;
- the need to achieve a sustainable disinflation, taking into consideration the convergence with the European Union.

Setting the second semester of 2005 as the moment of adopting the IT strategy resulted from the completion, largely, in early 2005, of the preparatory process. The process consisted in the fulfillment of some economical, technical and institutional requirements and criteria. These premises were accomplished as follows (NBR, 2005):

- The inflation rate reached a one-digit value (9.3%) at the end of 2004;
- The NBR had benefited from a complete operational independence by strengthening both de jure (via the new NBR Statute effective 30 July 2004) and de facto independence of the NBR;
- The successful des-inflationist had increased the credibility of the central bank;
- Fiscal dominance had disappeared;
- Financial sector was stable and sound, but exhibited low financial depth;
- Since 2003 the NBR had published periodical reports on inflation.

An important aspect worth mentioned here as a preparatory measure is the changing in the type of nominal exchange rate. In October 2004 the Board Council of Administrators of the NBR decided to implement a favorable policy to increase the flexibility of the exchange rate, going from a hard managed floating to a soft managed floating exchange rate (see Figure 5); the benefits consisted in: stabilizing the exchange rate at a lower value diminishing the Romanian economy’s vulnerability to exchange rate movements, a nominal exchange rate compatible with IT and fewer intervention of the NBR on the currency market.

Once the inflation targeting has been adopted, NBR chose a new set of communication instruments for increasing the degree of the monetary policy transparency:

- monetary policy strategies, by presenting the objectives, priorities and the short and medium term monetary policy risks;
- the Inflation Report with biannual frequency starting from 2001, and published quarterly from 2005;
- Press Communicates after the Board meetings, in which can be undertaken modification of the monetary parameters;
- Studies and International scientific conferences.
The Romanian IT is established in terms of Consumer Price Index (CPI), having a band of ± 1%, annual targets of an initial two-year horizon (this target is established in conjunction with the Government). In the second part of 2005, NBR has announce the ± 1% target range and the time horizon, which initial was at six quarters and after enlarge at eight quarters at the end of 2006. The rationale for choosing CPI instead of core-inflation it is justified by CPI's larger public transparency and availability.

The CPI is determined by the National Statistical Institute, which is an entity independent from the NBR. Core inflation has an analytical role and it is calculated by the central bank as following:

- CORE1 = CPI – administered prices;
- CORE2 = CORE1 – volatile prices (vegetables, fruit, eggs, fuels);
- Adjusted CORE2 – the influence of excise duties and vice tax is removed.

The ex-ante definition by the NBR of some exemption stipulations refers to:

- substantial growth in the external prices of energy sources and raw materials;
- natural catastrophes or other extraordinary event with strong impact on inflation through costs and demand, including unpredictable changes on the agricultural products market;
- considerable fluctuations of the exchange rate of RON caused by factors outside the national economic and monetary policy;
- major deviation of the administered prices from the schedule of price corrections announced by the Government in terms of value and timetable of implementation;
- deviation of fiscal and income policy from the schedule of their implementation.

After adopting the IT regime, the inflation rate entered a downward trend. In 2005 Quarter 4 the annual inflation rate stood at 8.6%, overshooting with ±1.1% the target of 7.5% established for 2005. The main reason for the deviation of the inflation rate was the unexpected large supply side shocks augmented by the excess demand in the final months of 2005. Although the target was missed the disinflation process continued also in 2006, with an annual inflation rate at the end of the year of 4.8%, slightly below the 5% target. At the end of the Quarter 4 of 2007 the annual inflation rate reached 6.57%, well above the target of 4% and the ±1% variation-band. The main reasons of this development were the supply of agri-food items, the depreciation trend of the national currency and demand, including unpredictable changes on the agricultural products market;
the adverse influence exerted by higher fuel prices (see Figure 6).

Starting Quarter 3 of 2008 the inflation rate entered a downward trend, the annual inflation rate at the end of September being situated at 7.30%, remaining outside the ± 1% variation-band around the target of 3.8%.

At end of 2009, the 12-month CPI inflation rate went down to 4.74%, with a margin of 0.24% above the upper limit of the 3.5% target for 2009 and the ±1% variation-band. Also the rate situates with 0.2% below the September reading of 4.94%. “The persistent negative GDP gap and the LEU exchange rate dynamics were conducive to the decline in consumer price inflation. Nevertheless, their contribution was largely offset by the adverse impact of supply-side factors, and particularly by the hikes in excise duties on tobacco products” (NBR, 2010: 8-9).

As for 2010 and 2011 the NBR inflation report for February 2010 shows that disinflation process will continue. Thereby the annual CPI inflation rate is places, according to Figure 7, at 3.5% for end-2010 and 2.7% for end-2011. CPI inflation is expected to return inside the variation band around the central targets, i.e. 3.5 percent in 2010 and 3.0 percent in 2011, as early as the first part of the current year.

4. Romania’s current position in its way to the Euro zone

The launch of the single European currency is certainly the most significant global financial event, since the breakdown of Bretton Woods International Monetary System. This is a milestone in the European construction, which is part of an ongoing process started over 55 years ago, with the establishment of the European Coal and Steel Community (ECSC) in 1951 and the signing of the Treaty of Rome in 1957.

According to the timetable for adopting the single European currency, Romania will be adopting euro sometime between 2012 and 2014. However, to adopt the single European currency, our country must meet a series of economic criteria in order not to destabilize of
the European economy and to affect the exchange rate of euro against other international currencies. These conditions are specified in the Treaty establishing the European Union (Maastricht Treaty, entered into force on November 1, 1993).

The convergence criteria required to be fulfilled by a country in order to adopt the single currency refer to real and nominal convergence criteria.

With regard to nominal convergence, the criteria involved are mandatory and explicit for two reasons: on the one hand, in order to participate in a monetary union is essential, firstly, the harmonization of monetary policies of member countries, to which adds the observance of the budgetary discipline, on the other hand, nominal convergence can be achieved in a much shorter time than is necessary for real convergence, which is a long process, especially for former planned economy countries. However, of a great importance is the fact that nominal convergence criteria must be met in a sustainable manner to enable their medium and long term compliance and not only achieving a certain level at a specific time.

Nominal convergence criteria concern the following aspects: there must be a sustainable degree of price stability and an average inflation rate, observed over a period of one year before the examination, which does not exceed by more than one and a half percentage points that of the three best performing Member States in terms of price stability; there must be a long-term nominal interest rate which does not exceed by more than two percentage points that of the three best performing Member States in terms of price stability; the ratio of government deficit to gross domestic product must not exceed 3% and the ratio of government debt to gross domestic product must not exceed 60%; the normal fluctuation margins provided for by the Exchange-Rate Mechanism (ERM II) must be respected without severe tensions (no more greater than +/-15%) for at least the last two years before the examination.

The Maastricht Treaty also stipulates the achievement of a legal convergence that refers to the compatibility of the national legislation of each member state with derogation, including the NBR statute with the provisions of the Treaty, the Statute of the European System of Central Banks and the European Central Bank.

The current international financial crisis makes it harder for Romania to accomplish the task of euro adoption. Even though the turmoil on international financial markets had no significant direct repercussion in Romania, it increased uncertainty and the difficulties in economic and monetary policy management. The accomplishment of the Maastricht criteria requires – in these conditions – more discipline and strictness, prudent fiscal and budget policies, balance between wages and productivity growth, less expansive income policies – generally unpopular measures, which raise the question of the political cost ownership. Current estimations of foreign experts postpone euro adoption in Romania for a year, being expected to achieve in 2015, considering two of the most disturbing factors: the fiscal deficit which widened over the reference threshold, and the exchange rate that has become more unstable.

Adoption of euro by Romania at the appointed time (2014) through the Convergence Program submitted to the European Commission in early 2007 depends on the simultaneous compliance of both nominal and legal convergence criteria. Among the nominal convergence criteria, Romania continues to meet only the criterion of public debt, according to Table 1.

Inflation in Romania has been having a sustained downward trend for the past several years, until 2006, due to...
an appreciation of the LEU started in 2004 (as we have seen in Figure 5 and 7). The disinflation process was quite visible according to the 12-month average of the HICP, which fell to 5.6 percent in 2009 Q4 (down by another 0.6 p.p.). Nevertheless the gap between the 12-month average of the HICP in Romania and the corresponding Maastricht criterion continued to be significant (4 p.p.), given that, throughout 2009, the domestic economic agents were slower than those in Western-European economies in adjusting to the unfavourable environment shaped by the global economic and financial crisis and that the shock generated by the change in the excise duties was a significant one. The comparison to the 12-month average of the HICP in EU27 is even more unfavourable (a 4.6 p.p. gap), considering that four of the Member States posted negative average 12-month inflation rates in December 2009 (NBR, 2010: 15).

In Romania in 2005 were launched the first issue of bonds maturing in 10 years, which were sold at an annual interest rate of 6.75%. Until 2005 on the domestic market have been issued bonds with a maximum maturity of 5 years. According to the Convergence Report in May 2008, for the reference period April 2007 – March 2008, long-term interest rates in Romania were at the average level of 7.1%, above the reference value of the interest rate criterion. In 2009 this level was situated at 9.7%, with a gap of 4.4 p.p. over the corresponding Maastricht criterion. Interest rate criterion is closely related to inflation criterion so that, through the consolidation of disinflation Romania could fulfill this criterion.

As it can be seen in Figure 8, the budget deficit criterion has been met by Romania until 2007, the budget deficit always being under the reference value of 3% of GDP since 2002. After 2008, this criterion has been seriously affected in case of Romania by disruptive factors of global crisis, in 2009 being with 4.4 p.p. more than the limit.

Regarding the debt ratio to GDP, according to Figure 9, the level of 21% registered in Romania in 2009 is comfortably below the reference value of 60% of GDP, but with an increasing rate since 2006. Even though a major proportion of total public debt is denominated in foreign currency (more than 60 p.p.), the general low level decreases the sensitivity to its currency risk.

The last but not the least is the exchange rate stability criterion. For now, the national currency of Romania is not participating in the Exchange Rate Mechanism II (ERM II), anticipating that entry will not occur until 2012. Consequently, it has not yet been defined a central rate against which the framing of the exchange rate fluctuations can be appreciated within a band of ±15%.

Timing of ERM2 entry is planned for 2012 in order to (Popa C., 2009):
- provide some monetary and exchange rate flexibility (for a limited time period) in order to further necessary and substantial structural adjustment;
- maintain motivation to carry out reforms in a timely manner and consolidate macro discipline (need for significant fiscal consolidation in 2010 –2012);
- provide the possibility of setting the central parity based on a more accurate estimate of the equilibrium exchange rate after overcoming both the peak in capital inflows (which remained high even subsequent to EU accession), as well as the substantial and abrupt reduction in flows to EM after the onset of the global financial crisis;
meet *ex ante* most of the convergence criteria and establish sustainability.

The euro adoption will generate permanent benefits for Romania, but this decision will not be cost free. The immediate effects will be eliminating the transaction costs and the exchange rate risk, the increase of investment, of macroeconomic credibility that will diminish country risk. Moreover, the euro adoption will foster financial integration with the European market, which can improve financing conditions of Romanian companies.

Looking ahead, real and nominal convergence process in the Romanian economy will achieve a rate which depends, to a great extent, on the overall consistency of economic policies implemented by the authorities, which is why we believe it is appropriate that the guidelines of the economic programs are to be strictly observed, beyond the short horizon of an election cycle.

5. Possible changes in the IT strategy in the context of Romania’s entry in the ERM II

With the view of joining the Euro Area in the near future Romania faces a great challenge, that of finding a way to organize the transition from its current exchange rate regime to the irrevocable fixity of exchange rate against other Euro Area currencies, taking into consideration the need to maintain a certain level of price stability.

According to the literature in the field a stable exchange rate while participating in the ERM II has a beneficial effect in fostering lower and less volatile inflation. A fixed rate fosters price stabilisation not only directly, by stabilising import prices, but also indirectly by stabilising inflation expectations. Nevertheless in the case of the standard a 15% fluctuation band, which permits sizeable exchange rate fluctuations (and where there is also the possibility of revaluation of the central rate), this stabilising role is limited.

As we have discussed, a strategy of IT is being pursued in the Romanian economy. In this context the question arises whether IT is consistent with ERM II. In a small open economy, a relatively stable exchange rate is vital for price stabilisation. Accordingly, close attention is paid to exchange rate movements within the IT regime. However, the ERM II goes further by explicitly setting a quantitative exchange rate target. In an environment of IT and simultaneous participation in ERM II, two monetary policy objectives exist alongside each other: a target for inflation and a target for the exchange rate. This may undermine the comprehensibility of monetary policy and affect the NBR’s credibility and the effectiveness with which it performs its stabilising activities. This problem is reduced if participation in ERM II is limited to the short period of two years. In the case of a longer stay in the ERM II, or insufficiently compatible economic policies, the combination of IT and the fixed exchange rate with a fluctuation band could generate macroeconomic pressures.

In order to prepare for the membership of the ERM II with the objective of full participation in the European Monetary Union, Romania has moved through various types of regimes with ultimate shift being the adoption of the single currency. It has started with a fixed exchange
rate regime and moved gradually from an intermediate (soft peg) regime to a managed floating regime. In the present the national currency has a managed floating exchange rate against euro.

In conclusion IT, as the current national monetary policy regime for Romania, is to be maintained at least until the ERM II entry (2012). As we have seen the co-existence of IT with an explicit exchange rate objective is quite problematic, although the two goals are not inconsistent, since in the medium run the international value of the currency can be stable only if its internal value is stable.

6. Conclusions

Romania, like any other country that is a member of the European Union and intends to adopt euro as a means to achieve its objective of full participation in the EMU faces a number of challenges/obstacles that will not make the process an easy one. In this paper we have presented these challenges in terms of the IT regime.

After the failure of money targeting in the mid-1980’s and the collapse of fixed exchange-rate-peggs in the early 1990’s a new monetary policy framework was needed. In this context IT with floating exchange rates emerged as the new monetary regime of choice. According to the Bank of England report from January 2010, at this moment there is a number of 27 central banks considered fully fledged IT-ers, and many others in the process of establishing a full IT.

The NBR shifted to direct IT in August 2005 in order to strengthen disinflation and bolster the central bank’s credibility. This monetary policy strategy was adopted after completing a preparatory process, whose last stage was to set up and test the functioning of the economic analysis and monetary policy decision framework specific to IT. Another important aspect is the fact that among the preparatory measure one of them consisted in changing the type of nominal exchange rate. In October 2004 the Board Council of Administrators of the NBR decided to implement a favorable policy to increase the flexibility of the exchange rate, going from a hard managed floating to a soft managed floating exchange rate, these benefits consisting in: stabilizing the exchange rate at a lower value diminishing the Romanian economy's vulnerability to exchange rate movements, a nominal exchange rate compatible with IT and fewer intervention of the NBR on the currency market.

A set of nominal and real convergence criteria must be achieved by Romania to be eligible to adopt the euro, one of them implying that Romania must spend at least two years in the ERM II, keeping its exchange rate towards the euro stable, inside a band of ±15%. To NBR this action consists in the fact that it must find the proper instruments to assure a smooth transition from its current exchange rate regime to the irrevocable fixity of exchange rate against other Euro Area currencies. That is why NBR’s attention will shift back from price stability to the exchange rate anchor, implying that the current form of IT will be maintained at least until the ERM II. The timing should be configured to ensure the likelihood of shorter necessary stay in ERM II, given the fact that there is an inflation targeting framework to which exchange rate movements should be clearly subordinated. That is way an exchange rate arrangement involving the national currency, the LEU, and the EURO must be adapted to the particular economic conditions of Romania and to the policy commitments of the relevant national authorities.

Bibliography
