POSSIBLE IMPLICATIONS OF ADOPTING THE SINGLE EUROPEAN CURRENCY FOR THE ROMANIAN ECONOMY

Sandu Carmen
„Al. I. Cuza" University of Iaşi Faculty of Economics and Business Administration Adress: B-dul Carol I,nr. 22, Iaşi 700505 E-mail: sandu_carmen@yahoo.com Telephone: 0740/852.842

The actual preparation and adoption of the euro is, for Romania, the most important challenge of the first decade after its accession at the EU. It puts to the test the policy and administrative capacity to conceive and implement a coherent program of measures that will ensure real and nominal convergence and puts pressure on the economic system, which ultimately takes over the adjustment task.
Beyond these general guidelines raise numerous questions concerning the preparation process of the euro adoption, the implementation timetable and the impact of the changeover to the euro on the Romanian economy.

Key words: euro, exchange rate, Economic and Monetary Union, convergence criteria, ERM II, NBR, ECB, IMF, financial crisis.

Cod JEL lucrare: F15, F36

1. Introduction

Romania became a member of the Economic and Monetary Community on the 1st of January 2007, with derogation from adopting the euro as its currency. The exemption granted to Romania and to the other new members who joined after 2004 implies that these countries commit themselves irrevocably to replace their national currency with the euro, but they can choose when to demand approval for the integration in the euro area. European institutions, namely the European Commission and the European Central Bank, are called upon to evaluate and report to the Council of the European Union the progress of each country individually, aiming in particular at the way that economic and financial convergence is achieved, and following a set of distinct criteria established by the Maastricht Treaty (the founding document of the Economic and Monetary Union signed in 1992).
The entire process of adopting the single european currency, which implies the fulfillment of several strict formal criteria, was designed to reduce the risk of a weakening or even destabilization of the European monetary system when integrating economies with severe imbalances, protecting at the same time the economies of the countries joining the euro from the possible shocks resulting from direct confrontation with the euro area.
Waiver of its own currency and the related policy instruments transfers the task of adjusting the national economy to the asymmetric shocks coming from the Economic and Monetary Union area towards other directions – fiscal policy, wages and prices. This concerns mainly the economies with a structure and development level inferior to the European average which are thus more exposed to the risk of asymmetric shocks. Therefore the preparation process for the adopting of the euro focuses on the convergence or the adaptation of less developed economies to the European standard and structure; that explains the precautions in advancing towards the euro of most of the new entrants into the EU, whose GDP per capita is, in many cases, less than half of the European average.
So far we only have a very general idea of the trajectory that Romania plans to follow in adopting the euro. Both the Convergence Program and projections of the NBR want to achieve a gradual progression towards fulfilling the Maastricht criteria, so that in 2012 Romania would adhere to the ERM2 exchange rate mechanism for a minimum of two years, and that the actual shift to the euro would be possible in 2014.

The crisis affecting at this moment the international financial system introduces an additional factor of uncertainty and if prolonged, it may complicate the process of adopting the euro in Romania. On one hand, the management of the real and nominal convergence process becomes more difficult; on the other hand, the current crisis may prove to be the most serious test for the European financial system and its currency, the euro.

2 Adoption of the euro - the last stage of a complete integration

The benefit of a country's accession to a monetary union is the enhancement of foreign trade, which then leads to a faster economic growth. Equally noteworthy are the positive effects resulting from an increased financial discipline, the significantly improved acces to the capital and the stability offered by the capital market forming at a union level.

The strategy that our country will have to adopt for the changeover to the euro must identify the conditions to be met so that the Romanian economy would fully benefit from adopting the euro, the sequence of measures to be taken in order to ensure these conditions, but also their implementation timetable. A detailed analysis of the experience of other countries which have undergone the process of adopting the euro or which are preparing to do so would be particularly useful since it may help avoid some mistakes and identify appropriate solutions – however without losing sight of the particular situation of each country.

The transition process towards adopting the single European currency by our country requires the fulfillment of the nominal convergence criteria set by the Maastricht Treaty in order to participate to a precursory stage within the ERM II mechanism. These criteria are detailed in the Protocol on the convergence criteria and operationalized by the European Central Bank during the evaluations that it makes regularly. In the Report concerning the convergence it is estimated that Romania will not be able to join the ERM II[212] before 2012, and the adoption of the euro is thus anticipated for the year 2014.

The current positioning of the Romanian economy concerning the fulfillment of the nominal convergence criteria is briefly presented in the table below:

Table no.1: The Maastricht criteria at the level of Romania
(Nominal convergence indicators)

Nominal convergence indicators	*Maastricht criteria*	*Romania 2007*
Inflation rate (percent, annual average)	<1.5 pp above the average of the most performant 3 EU members	4,9
Consolidated budget deficit (percent of GDP)	below 3%	2,5
Debt (percent of GDP)	below 60%	13,0
Exchange rate (RON/EUR) (maximum procentual appreciation/depreciation compared to the average over 2 years)	+/- 15%	+10,8/-9,6
Long-term interest rates	<2 pp above the average of	7,1

212 From the 1st of January 1999, when the single European currency was adopted, the multilateral exchange rate ERM (passed in'79) was replaced with bilateral one, ERM II, in which each participating currency has a defined central parity comparing to the euro, the fluctuation band maintaining the same (± 15%). ERM stands for Exchange Rate Mechanism (exchange mechanism).

(percent per year)	the most performant 3 EU members	

Source: ECB, Convergence Report, May 2008

The Treaty stipulates that adhering countries must "achieve a high level of price stability; this will be highlighted by an inflation rate which gets close to, at most, that of the three member states with the highest performance in terms of price stability".

The Protocol states that last year's average inflation is considered and that it should not exceed by more than 1.5 % the average of the three countries of the EMU which have the best performance. The member countries with the lowest inflation during the period prior to the publication of the last ECB report (April 2007-March 2008) were Malta, the Netherlands and Denmark, which had an average inflation of 1.7%, thus resulting a reference value of an average inflation of 3.2% against which candidates are evaluated.

Regarding the situation of public finances, the Treaty stipulates "the sustenainability of the government's fiscal position; this will be highlighted by achieving a governmental budgetary position without an excessive deficit". The Protocol states that this means that at the time of the examination, the member country candidating for the EMU should not be the subject of a Council decision which draws attention on the existence of an excessive deficit. The procedure in case of an excessive deficit is initiated when:

-the ratio between planned and achieved government deficit exceeds the reference value of 3% of GDP (with some exceptions which take account of temporary or exceptional circumstances);

-the ratio between government debt and GDP exceeds a reference value of 60% (also with a tolerance for cases in which public debt is close to this level and falling).

Regarding the evolution of exchange rates, the Treaty stipulates "the enclosing within normal fluctuation limits set by the exchange rate mechanism of the European Monetary System for at least two years without depreciation against the currency of any Member State". Since January 1999 the ERM has been replaced with ERM2; as a consequence, the exchange rate stability condition for a two year minimum period is now being judged against the euro.

The Treaty also refers to the long-term evolution of interest rates which requires that "the soundness of the convergence achieved by the Member State and its participation in the exchange rate mechanism of the European Monetary System reflect in long term interest rates".

Protocol mentions that this stipulation means that, during the year prior to the examination, long-term interest rates (measured in interests on long-term government bonds or comparable instruments) should not exceed by more than 2 percentage points the average interest rate achieved by the three member states with the best performance in terms of price stability. For the period April 2007 - March 2008, the reference value resulting from the addition of 2 percentage points to the average interest rate in Malta, the Netherlands and Denmark is of 6.5%. Romania has declared an average rate of long-term interest of 7.1% above the reference value, for that same period.

The evaluation of the opportunity of joining the ERM II also takes into account the achievement of some real convergence criteria, which, although not expressly mentioned in the Maastricht Treaty, have a high predictive content concerning the success of this process. Fulfilling the real convergence criteria ensures a high degree of cohesion for the economies of the member countries of a monetary union. The main criteria considered are: the real level of GDP per capita, sectoral structure, the degree of openness of the economy and the trade share with the EU in the total foreign trade.

Figure no. 1: Evolution of GDP per capita in Romania between 2001-2007

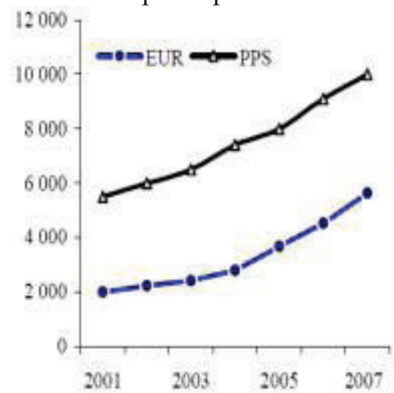
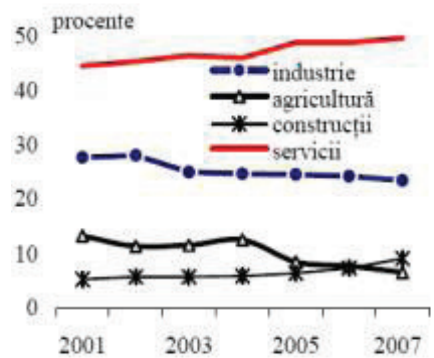


Figure no. 2: Evolution of the share of economic sectors in GDP between 201-2007



Source: EUROSTAT, NIS, NBR Source: NIS, NBR

During the previous years, the changes in GDP per capita expressed according to the purchasing power standard registered a sustained growth. Regarding the structure of the economic sectors in Romania during the period under review, you can see an increase in the share of services and construction in GDP, amid a decline in share of industry and agriculture.

Romania will face a difficult recession in 2009, but the economy will avoid collapse, particularly as a result of a relatively low debt of the private sector and of reduced dependence to exports. For this year, we can predict a contraction of the Romanian economy by 4% and a budget deficit of 5.1% of gross domestic product (GDP), based on IMF estimates. Annual inflation would moderate to 4.9% at the end of 2009, compared to 6.3% in December 2008. We can expect the need for the expansion of state funding to increase the debt significantly, from 16.3% of GDP in 2008 to 22.5% this year. For the current account deficit a steep correction is estimated, up to 7.1% of GDP this year from more than 12% of GDP in 2008.

Romania's exports and imports will register an actual growth of 8.1% and 3.7% respectively this year, and 9.6% and 4.9% respectively in 2010. Regarding inflation, analysts foresee an annual rate of 4.9% for 2009 and of 3.7% for 2010, provided that the National Bank of Romania (BNR) maintains its cautious position until fiscal policy is more accurate and there is more stability on the currency market. Thus, analysts anticipate that the loosening of monetary policy will take place in the second half of this year and will lead to the reduction of interest rates to 8.5% from the current 10%.

However we must admit that a successful implementation of the IMF program along with a faster comeback of the national currency may cause the NBR to reduce interest more aggressively than currently anticipated. Analysts see a possible reduction of the rate to around 4.12 RON/euro at

the end of the year, compared with the current estimates of 4.2 RON/euro, in the context of the currency return as a result of the agreement with the IMF and the recent improvement of investor's confidence which was stronger than anticipated.
In 2010, the Romanian economy would return to the growth, with an estimated advance of 0.3% of GDP for the next year, an inflation of 3.7% at the end of the year, a budget deficit of 4% of GDP and a current account deficit of 6.8% of GDP.
Although average incomes are well below average in the euro area, GDP per capita climbed significantly over the past decade, and increasing trade integration, financial and institutional integration with Europe should support real convergence in the long term.
According to a report by the International Monetary Fund[213] (IMF), Member States of Central and Eastern Europe facing problems should quit the national currency in favour of the euro. IMF experts believe that the changeover to the euro should be made without states becoming members of the euro area and hold a place in the Governor Council of the European Central Bank. For the EU states, adoption of the euro offers advantages in terms of solving problems such as overlapping debt in foreign currency, removing uncertainty and restore confidence. Without the euro, solving the problem of foreign currency debts would require a massive reduction in spending in some states, under the conditions of a growing political resistance.
But there are also skeptics who claim that Romania will fail to adopt the euro in 2014, stating that the minimum real convergence will not be achieved, thus outrunning the changeover to the ERM II, and thereby the shift to the euro. However, failing to achieve nominal convergence criteria could be an impediment for which Romania will adopt the single currency in 2015, motivated by increased inflation and budget deficits. The current financial crisis in the United States, and not only, could also affect the adoption of the euro by Romania.
In my opinion, reducing inflation is crucial at the moment; locating it to sustainable levels, along with a more rigorous control on aggregate demand, will create favorable conditions for achieving nominal convergence. And as regards the crisis, it is still premature to assess the degree of impact that it will have on Romania, especially since the NBR measures on credit have been severe and Romanian banks kept their distance from "toxic" credit products. However, I believe that with sustained efforts from the Romanian authorities in maintaining a strict budgetary policy and the continuation of reform, taking into account the turmoil in international markets, Romania could adopt the euro on the 1st of January 2014.

3. Financial crisis - a challenge for the Romanian economy

From a historical point of view, financial crises have a common cause. They follow a period in which the low level of interest and inappropriate risk assessment generate a state of general euphoria. This period is then followed by a collaps one, when it becomes clear that the situation can not continue.
Most financial analysts estimated that the origin of the current financial crisis would be the dramatic lowering of the cost in the U.S. housing market or the collapse of the housing credit market. One can say that is an incomplete vision. The root causes of the financial crisis are deeper, both macroeconomic and microeconomic in nature, as several analysts recently recognized, the two types of causes interacting in the production of the crisis.
The effects of the international financial crisis were also felt in the Romanian economy. The banking system was slightly affected since it has not been exposed to toxic assets, but also due to administrative and prudential measures taken in time by the NBR. However, the international

213 IMF is an international organization which has 185 member countries, established to promote international monetary cooperation, currency stability and systematic currency agreements in order to to stimulate economic growth and high levels of use of labor force, and to provide temporary financial assistance to member countries in appropriate circumstances, to adjust the balance of payments. Upon joining the IMF, each country contributes with a certain amount of money called "quota subscription".

financial crisis and its consequence in particular – the recession in developed countries - is expanding throughout the Romanian economy in several directions.

From the commercial point of view, it slows down export growth or even reduces it. On the financial direction, it limits the access to external financing and thus restricting the volume of credit, and creates difficulties in the private external debt.

The effect on the exchange rate, due to the reduction of external financing, was the depreciation of the national currency. The withdrawal of investors from esteuropean countries resulted in moments of panic and speculative attacks on the monetary- foreign currency market, such as the one in October in Romania, which needed the NBR intervention.

The propagation of these effects results in an extremely high level of uncertainty regarding the progress of economic variables. Romanian economy has a high current account deficit, indicating its dependence on external financing. We have to choose between the orderly reduction of the deficit and its reduction by the market in the current conditions of tension and mistrust, with dramatic consequences for the exchange rate and economic growth.

After years of strong economic development with GDP growth rates of over 7%, massive direct foreign investment and relatively well developed exports, the Romanian economy is now threatened by a severe crash.

International financial crisis has massively reduced the demand on the major Romanian foreign markets: Germany, France and Italy, causing problems for the Romanian industry. Since the beginning of the year, many Romanians have lost their job, and unemployment rate could increase from 5.3% to 7% this year.

Romania is not the only country in the European Union facing problems. One can anticipate a decline of 3.6 percent for countries that use the single currency. Other states from the area of our country have also suffered: the Serbian economy will decrease by 2.1%, while Slovakia with 1.2 percent. Hungary faces a more serious situation, since its economic setback could reach 5.1%, while Croatia's 4.5 percent.

Romania is, after Hungary and Latvia, the third European Union member country forced to ask for help to the IMF and EU. From the crisis fund of the EU, from which Hungary and Latvia have already received 6.5 respectively 3.1 billion, remain another 15 billion. The fund was designed to help EU members outside the euro area, arriving in need of payment. The EU Commission also expected that EU countries whose economies have close connections with Romania to join in and help with loans. In the case of Latvia for example, loans have come from Sweden and Estonia.

Romania is now in the position of going to the bank and demanding for as many loans as possible, but without being sure that it can pay back the rates in the future. It counts on the fact that the crisis will pass, and the economy will start to thrive again. In addition, once entering the euro area in 2014 and adopting the euro, we will no longer have financial problems. Specialists in economics think that, unlike previous years, when foreign loans and money from privatizations were franatically spent in consumption, in compensatory payments and other purposes, this time things could be different. The difference is that now we will have more eyes riveted on Romania. If the IMF allowed enough during the 10 agreements so far, with the EU the situation is slightly difficult. The European Commission will be watching, controlling very carefully everything that happens. Brussels has every reason to save the East, especially since the economic interests of the area are very high.

Signing the agreement will give Romania the touch of credibility needed in the current international context. Money from the IMF, held at the National Bank, will help authorities maintain the currency if the RON will be submitted to further speculative attacks. We will have the surety that our currency is healthy, and will no longer suffer depreciation shocks from the estimations from 3 to 5 lei, which would lead to an economic failure and increased poverty. And last, but not least, the loan could allow the National Bank to provide the banks with more money by reducing minimum reserve requirements, which will boost lending. Part of the money will pass through the branch of the Ministry of Finance and towards the Savings Bank and Eximbank, the two state banks, in order to support lending, especially to the SMEs and exporters.

So far, the International Monetary Fund has granted 47.9 million dollars to several countries affected by economic crisis, including Belarus, Hungary, Latvia, Pakistan, Serbia and Ukraine. The two member countries of the European Union were granted funds after the conclusion of joint agreements with the European Commission, World Bank and IMF. Thus, Hungary has received 29 billion in October, while Latvia received 7.5 billion in December. Following the agreement signed with international institutions, Budapest will have to reduce budgetary expenditure, reduce the budget deficit below 3% of GDP and implement a series of structural reforms, including a reform of the tax system. In this regard, a series of measures has already been announced, including the increase to 23% of the value added tax (VAT) starting with July 20th from 20% as it is now, and the loosening of fiscal policy on the labor market. These measures also include significant changes in the social insurance and pensions system. In the case of Latvia, the IMF demanded the reduction of public sector salaries by 15%, maintaining a constant level of exchange rates, the increase of taxes and a drastic reduction of public spending. Romania should pay attention to the case of the countries mentioned and propose optimal strategies which would not affect the Romanian economy.

The danger of an agreement with the IMF is worth taking into considerantion, namely that IMF grants money in rather harsh conditions, which do not encourage growth, but follow entirely different indicators. IMF does not adapt its solutions to the economic needs of the borrowing country and applies the same treatment to all, even if in some cases (see Korea, Argentina) it is an obvious failure. Decisions taken in the IMF board are taken by rich countries, whose economic interests do not always coincide with those of the Member to whom it borrows money.

4. Conclusions

Adopting the euro is the *ultimate test* for the Romanian economy, is the most important project of the first decade after joining the EU. The success of this project depends on the mobilization of political and social forces towards continuing the reforms necessary both to achieve nominal convergence criteria and increase the competitivity of the Romanian economy so that it would face the pressures that may occur with the loss of the shield provided by the independence of the monetary policy and exchange rate fluctuation.

However, international financial crisis should not be neglected, since it makes the task of adopting the euro by Romania more difficult.

Although it does not have direct repercussions in Romania, the turmoil on international markets increase uncertainty and the difficulties in managing the monetary and economic policies. But the current financial crisis also highlights the advantages for smaller states in particular, which benefit from protection under one of the strongest currencies in the world-the euro.

Bibliography

1. Copeland, Laurence S. - Exchange Rates and International Finance, Pearson Education, Great Britain, Fourth Edition, 2004

2. Chris Mulhearn, Howard R. Vane - The Euro: Its Origins, Development and Prospects, Edward Elgar Publishing, 2008

3. Dimitris Papadimitriou, David Phinnemore - Romania and the European Union: from marginalisation to membership, Routledge, 2008

4. Jorgen Orstrom Moller - European Integration: Sharing of Experiences, Institute of Southeast Asian Studies, 2008

5.Peter B. Kenen, Ellen E. Meade - Regional Monetary Integration, Cambridge University Press, 2008

6. Voinea, M. Gheorghe - Relaţii valutar- finaciare internaţionale, Editura Universităţii „Al. I. Cuza”, Iaşi, 2007
7.Anna Lipinska, The Maastricht Convergence Criteria and Optimal Monetary Policy for the EMU accession countries, European Central Bank Working Papers nr. 896, May 2008
8.European Central Bank, Convergence Report, May 2008, www.ecb.int
9. Raport asupra stabilităţii financiare- 2008, www.bnro.ro
10. www.imf.org