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Associate Professor Ramona Toma
"Lucian Blaga" University of Sibiu, Romania

EUROPEAN MONETARY UNION AND ROMANIA

Abstract: *Romania face the question of whether and in what time frame the economy will be capable of fulfilling the conditions for entering into the euro area. In general, those conditions can be understood as attaining such parameters in various fields of economic life that will ensure successful operation of the economy in the environment of the single monetary policy of the European Central Bank. This article analyzes the main issues of the euro adoption in Romania. In the medium term, an important challenge for Romania is to achieve real and nominal convergence. Within this framework, the Eurosystem emphasizes the need to perform real convergence in parallel with and not on the behalf of nominal convergence. The question of optimal timing of euro adoption has to be addressed.*

Key words: *euro adoption, convergence, Romania*

JEL Classification: *E31, E42, E60, F33*

After integration into the European Union, Romania have to decided the moment when to join the Exchange Rate Mechanism - ERM II and adopt the euro when all nominal convergence criteria set by the Maastricht Treaty are met. The main arguments to decide if it is a good idea to join a monetary union have been developed by Robert Mundell in many articles and books that have been published since the 1960s.

A clear and credible commitment to the euro that is shared in the public would have a stabilizing effect on expectations because investors would not fear a change in strategy even in hard times. Unfortunately, the euro enjoys less support than EU accession did and it is controversial in many of the old member states. For the new EU member states, euro adoption without a clear public and political commitment can be a risky strategy (Meyer and Jacobsen, 2005).

We consider that, today, the specialized literature in Romania is extremely scarce as regards works dealing with the problems of the European Monetary Union enlargement and its implications for the new

members. Cerna (1997) tries to give a global image of the process of European monetary integration and to draw conclusions for Romania. Ignat (2002) underlines the complex processes of European monetary integration, analyzing the conditions of a monetary union, the evolution from a common market to a single market, the constraints related to the transition to the euro, the position and role of the euro as an international currency. Dăianu and Vrânceanu (2002) shows the directions of action for a number of economic phenomena in the Romanian transition: reducing inflation, consolidating the external balance, increasing foreign capital inflows to Romania. They also analyze problems such as the convergence of economies in the integration process and the impact of globalization on the international financial system and on economic growth. Dăianu (2004) identifies a series of indicators of real convergence – per-capita income, work productivity, relative price convergence – claiming that a too early adoption of the euro could affect the equalization process because the compromise between economic growth and inflation.

Moreover, when Dăianu proposed certain models and solutions for Romania, these were ignored (postponing the liberalization of the capital account until after 2005 and inflation targeting until conditions made it possible). This fact have as result Romania's impossibility to fit in a model of monetary integration set at the level of the new EU member states, and thus *the necessity to formulate a credible strategy for euro adoption in Romania.* Setting a clear and credible date for the final goal helps to sustain the effort in order to meet the qualification criteria and to stabilize market expectations.

In order to adopt the euro, Romania must satisfy the Maastricht **nominal convergence** criteria on inflation, long interest rate, public debt, budget deficit and exchange rate stability. A euro-candidate country must therefore demonstrate before adopting the euro that its inflation rate is not excessively out of line with the rest of the euro area members. The long-term interest rate criterion serves as a means to assess the sustainability of the low inflation rate. The two fiscal criteria are to prevent free riding and spill-over effects and to ensure that a country will not have to resort to distortionary taxes to service a high debt level which would set back growth. The exchange rate stability criterion can be looked at as a “catch all” test, demonstrating that a country can live with exchange rate stability.

An analyze of the short and medium term fulfillment of the Maastricht criteria in Romania shows that there are some indicators with

positive developments (budget deficit, public debt) and another which have tended to be unfavorable for the Romania in the past, but which have improved in recent years (inflation rate, interest rate and exchange rate). Fulfilling only two criteria is not enough. Radical consolidation is necessary because the budget system will have to find sufficient resources to finance necessary infrastructure investments, which will in turn facilitate the process of real economic convergence.

Table 1: Indicators of Convergence in Romania

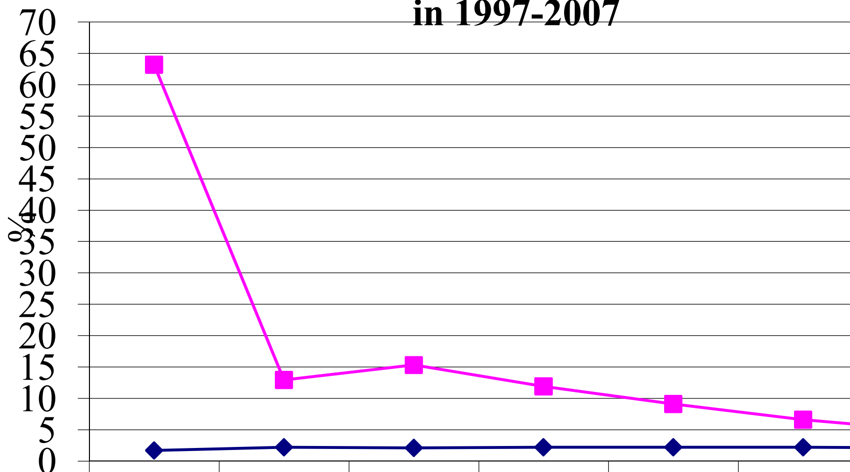
Indicators	2004	2005	2006	2007	2008	2009	2010
Budget deficit (% of GDP)	**-1.5**	**-1.4**	**-1.9**	**-2.7**	**-3.2**	**-3.9**	**n.a.**
Public debt (% of GDP, ESA 95)	**18.8**	**15.8**	**12.4**	**12.5**	**12.8**	**13.5**	**n.a.**
Index of consumer prices (%, annual average)	**11.9**	**9.1**	**6.6**	**4.8**	**7.0**	**4.5**	**3.6**
Long term interest rate (%, annual average)	**n.a.**	**6.5**	**7.2**	**7.7**	**n.a.**	**n.a.**	**n.a.**
Exchange rate (RON/EUR, annual average)	**4.05**	**3.62**	**3.53**	**3.31**	**3.55**	**3.45**	**3.38**

Source: European Commission - *Economic Forecast - autumn 2007*, European Economy no. 7/2007; National Forecast Commission - *Economic Forecast*, 2008

Although it is not easy to forecast the evolution of the ***budget deficit*** in Romania after January 2007, considering the experience of the other new EU member states we expect that budget income and expenses increase in the next few years. The budget deficit deteriorated from 1.9% of GDP in 2006 to 2.7% of GDP in 2007, mainly due to an increase in government consumption, in particular public wages and social transfers. Furthermore, under-spent public capital expenditure due to low execution of investment plans has been shifted to current spending through successive budget amendments. In 2008 and 2009, the deficit is expected to further widen to 3.2% and 3.9% of GDP respectively. Although the increase in budget deficit after accession is certain, its level depends

largely upon the budget programs that will be adopted and upon the amount of funds transferred between Romania and the EU.

The analysis of the evolution of ***public debt*** in the last few years reveals a decreasing tendency, with values below the limits set by the Maastricht Treaty, i.e. of 60% of GDP. In 2005, this was at 15.8% of GDP, 11% less than in 2000, fact that proves Romania's position is better than that of the majority of the new EU member states. Any estimate on the evolution of Romania's public debt after accession should consider the fact that the public debt will still be an important factor of economic growth, as a source of funding for investment projects in priority areas of the Romanian economy. Even though in the first few years following accession, it is possible that public debt increase in absolute figures, within the framework of the expected economic growth it will decrease in relative figures, thus being maintained between the limits set by the Maastricht Treaty. The public debt to GDP ratio is projected to increase by 1% between 2007 and 2009 to around 13.5% mainly due to higher deficits.



In Romania, the ***inflation rate*** in the year before accession was 6.6%, above the average of the Central and Eastern European new EU members before accession, of 2.8%. According to the estimates of the National Forecast Commission of Romania, the disinflation process

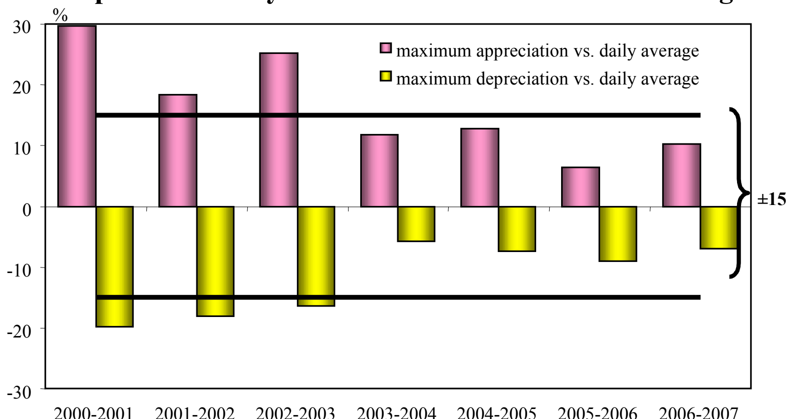
started before accession will continue after Romania's integration. In 2010, the inflation rate will be below 3.6%, meeting the criteria of the Maastricht Treaty, which stipulate that the inflation rate should be maintained below 1.5% above the euro area average.

The National Bank of Romania's monetary policy operates under a regime of inflation targeting with inflation targets set in terms of the national Consumer Price Index (CPI), but is necessary to take into consideration any methodological, and therefore also quantitative, differences between the CPI and the Harmonized Index of Consumer Prices (HICP), with which the Maastricht criteria operates.

Between 2002 and 2005, the ***reference interest rate*** dropped to an extraordinary degree, from 34.6% in February 2002, to 7.5% in November 2005, a level that was maintained until February 2006. Even if afterwards there were certain increases to 8.75% in August 2006 and to 9.03% in April 2008, considering the inflation targets set by National Bank of Romania, we could state that the interest nominal rate will continue its ascending trend.

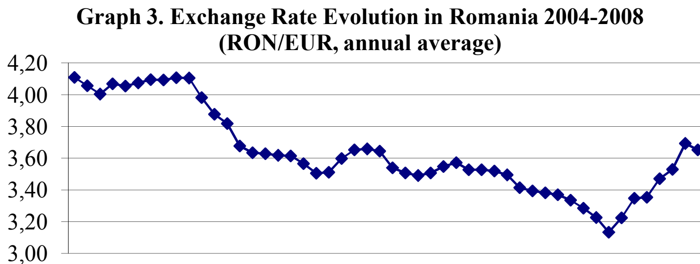
According to the data published by NBR, between 2000 and 2007 the leu/euro ***exchange rate*** experienced huge fluctuations.

Graph 2. Volatility of the Nominal RON/EUR Exchange Rate



Between 2000 and 2004, the leu depreciated from 1.99 RON/EUR, the average of 2000, to 4.05 RON/EUR, the average of 2004. In November 2004 was the starting point for the appreciation of the leu

vis-à-vis the euro, the average of 2005 being of 3.62 RON/EUR. In December 2007 the domestic currency posted its first nominal depreciation versus the euro (3.3%) in the last four years, reflecting the decline in investor appetite for risk against the background of heightened concerns following the US sub-prime mortgage crisis and its spill-over effects on the international financial markets. The National Forecast Commission estimates that the Romanian domestic currency will continue to appreciate, although not significantly, so that in 2010 the rate will be 3.38 RON/EUR.



Graph 3. Exchange Rate Evolution in Romania 2004-2008 (RON/EUR, annual average)

As regards the direct impact of the exchange rate on inflation through import prices, the recent nominal depreciation implies that the RON no longer has the disinflationary impact it had in previous years. In the medium run, the real exchange rate is driven by medium-term capital inflows or the productivity differential against major trade partners. Considering the heightened risk aversion on international markets and the recent developments, a slowdown is expected in the average appreciation rate.

Until 2004, the NBR exchange rate policy was characterized by rather frequent market interventions and low flexibility of the exchange rate, accompanied by a high predictability and low depth of the market. Economic developments of the 2004 made the central bank to change its strategy of exchange rate policy, even though the official regime was that of managed floating. Its reasons for such an approach were mainly related to its objective to discourage speculative flows, attracted by the huge interest differential, by the new strategy of monetary policy, but also by the utilization of the leu nominal appreciation as a means of strengthening

the monetary policy to support disinflation. In addition, it was necessary that NBR reduce its interventions in the market, thus limiting liquidity injections, which eventually would have had to be sterilized with significant costs.

Although the monetary independence of the NBR is currently limited to setting the key interest rates for RON, the lost of this possibility - through entering into the euro area - may have serious consequences. Impossibility to maintain different nominal interest rates in different EU countries causes serious problems as long as these countries experience different phases of the business cycle or different rates of inflation at the same time. Single ECB interest rate for EUR causes that countries which need a relatively higher real interest rate have relatively lower real interest rate instead, and vice versa. The only solution to this problem is the alignment of the business cycles and substantial reduction of currently divergent rates of inflation differentials within the eurozone countries. But in a monetary union the reduction of rates of inflation differentials is only possible after the price level gaps are substantially reduced, which in turn requires a higher level of the real convergence between EU countries.

Even if monetary policy strategy is internally consistent during the period of fulfillment of the convergence criteria, it might not necessarily be appropriate for the economy at that particular moment in time. For example, trying to keep inflation too low may result in an excessively restrictive monetary policy and a loss in the form of reduced economic growth. The opposite situation, an overheating of the economy, may occur if the exchange rate is fixed at too depreciated a level. A change of monetary policy regime entails considerable costs, especially if the previous regime has been in place for a long time and economic agents have adapted their behavior to it. For this reason, central banks usually resort to a change of regime only in situations where there is no other way out (Masson and Ruge-Murcia, 2005).

The National Bank of Romania's analyses suggest that speculative inflows of foreign capital had an important contribution to the rapid appreciation of leu. The real appreciation of the Romanian domestic currency combined with an increase in GDP would enable Romania to fill the gaps between its GDP per capita ratio and that of the EU average of the same ratio. On the other hand, excessive appreciation of the national currency could affect exports, with huge consequences upon the balance of payments.

The indicators of **real convergence** do not look fine: a weak convergence of the revenue level towards that in the euro area; a modest improvement in the conditions for business; many differences between the national financial market characteristics and euro area average. Insufficient alignment with the euro area economy could increase the costs arising from the loss of independent monetary policy. Greater labor market flexibility is thus still one of the key challenges going forward.

In the medium term, an important challenge for Romania is to achieve real and nominal convergence. Within this framework, the Eurosystem emphasizes the need to perform real convergence in parallel with and not on the behalf of nominal convergence. The advance of real convergence supports nominal convergence because the efficiency of monetary and fiscal policies is increasing when the causes of macroeconomic problems are reduced.

The question of optimal timing of euro adoption has to be addressed. The potentially most difficult nominal convergence criterion to satisfy is the inflation criterion. This is because the catching up itself means price level convergence that can be achieved by either higher inflation or exchange rate appreciation. The authorities' control in both of these areas is limited due to the unrestricted flow of capital and the associated constraints on domestic monetary policy. Giving up the tool of exchange rate policy can present problems.

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