EURO ADOPTION – THE ILLUSION OF THE MONETARY INTEGRATION OF ROMANIA*

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Abstract: *The accession to the European Union for Central and Eastern Europe countries involved their requirement to start the process of the European Monetary Union integration. The desire to enjoy the benefits of EU membership has made both the 10 countries that joined EU in 2004 and Romania and Bulgaria which became EU member in 2007 to engage on the path to join the European single currency endeavoring to meet not only the nominal convergence criteria but also real convergence. This paper makes an analysis of the Romania's capacity to achieve the nominal convergence criteria in the current context. The change of the financial and economic conditions due to the crisis that spread worldwide during 2007 - 2008 changed the issue from "Romania can fulfill the nominal convergence criteria?" in "Is it advisable for Romania to adopt the Euro, given the uncertainty clouds over the currency's future?" The analysis is made by considering the comparative situation of other countries that are in the process of joining the single currency. The objective of the research undertaken in this paper is to investigate Romania's capacity to approach the nominal convergence criteria and so realistic goal of joining the Euro it is.*

Keywords: Euro, European Monetary Union, Romania, nominal convergence, convergence criteria, Euro adoption
JEL Classification: E43, G01, F36

INTRODUCTION

The Romania's EU accession involves the adoption of the European single currency in a timeframe that depended on the degree of the economic integration with the euro area since adoption of the euro is part of the requirement for EU accession. Adopting the euro is a crucial step for the economy of a Member State, mainly because the power of the monetary decision, the monetary policy is transferred to the European Central Bank acting independently through a single monetary policy for the entire euro area.

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The European Central Bank's monetary policy targets a supposedly homogenous group of economies, not being possible to take into account the peculiarities of each. Therefore, an effective single monetary policy is subject to achieving a high level of homogeneity between national economies.

The Maastricht Treaty established several nominal convergence criteria to be achieved by every candidate intending to join the euro area. The criteria refer to the price stability (the evolution and the level of the inflation rate), the sustainability of the public finances and the indebtedness, the exchange rate stability and the long-term interest rates. In addition and maybe more important, determining the sustainability of the convergence process is possible by analyzing a series of structural alignment indicators as GDP per capita, the openness of the economy, the sectorial composition of the economy, the financing of the current account deficit, the wage developments, the degree of financial intermediation – all these indicators representing the level of real convergence achieved by a Member State.

Although the adoption of the euro is part of the requirement for EU accession the candidates from 2004 and 2007 waves of accession are considered member states with derogation.The status as Member State with a derogation gives the new Member States some leeway in setting the target date since there is no fixed timetable for the adoption of the euro. Of particular importance for setting the target date is the requirement for participation in the Exchange Rate Mechanism II (ERM) for at least two years and within a 15 per cent fluctuation range against the euro before adopting the single currency (Allam, 2009).

The analysis of these indicators helps to emphasize the rigidities in the economy and to assess its capacity to function effectively in conditions of the economic shocks.

Since 2007, Romania began the process of reaching the nominal convergence criteria for adopting the euro but after 5 year the current state of the assessment process of the nominal and real convergence to the euro area indicates the need for Romania to implement further measures to adopt the single currency.

Reaching this goal will involve greater efforts especially since the economic conditions and regional and global geopolitical are significantly different from those existing before the start of economic and financial crisis. Thus, in this period, a significant number of countries within the European Union are engaged in efforts to restore public finance sustainability, while paying attention to the evolution of the inflation rate.

In the year prior to EU Romania's accession, the monetary authority declares that "For the Romanian economy, joining the euro area is an extremely important strategic objective, the timetable for implementation was developed taking into account the benefits and costs that this process entailed (National Bank of Romania - Annual Report 2006).

In 2006, regarding the process of setting the convergence program, the NBR officials estimated that Romania will not join the ERM II earlierthan 2012. In terms of entry into ERM II in 2012 and minimize the duration of participation in this mechanism, the euro was seen as possible in 2014.

The first edition of the Convergence Programme, completed and published in January 2007 - after previous months when this project was submitted to the public debate – was a very important step for Romania, being the first document to evaluate the possibilities of economic development while promoting policies to achieve nominal and real convergence.

Currently Romania has set 2015 as the date of the accession to the Euro area and the opinions of the political factor, the monetary policy decision makers and the economists are not converging: if the President said that 2015 should be a target, the Romanian National Bank believes that this horizon should not be forced and some economists believe that in the current political and economic conditions the accession to the euro should not be a topic of discussion.

The changing of the economic, financial and political climate has modified the attitude of the countries that are in process of adoption the euro: in July 2011 the only accession countries with firm dates were Latvia 01.01.2014 and Romania 01.01.2015, Bulgaria, Czech Republic, Hungary and Lithuania currently do not have a target date for adoption of the euro (European Commission 2011).

1. ROMANIA AND THE NOMINAL CONVERGENCE CRITERIA

In the year prior to accession to the European Union, the Romanian National Bank made an analysis of the Romania's capacity to meet the nominal convergence criteria considering that "the Romanian economy has no problems in terms of sustainability of public finances, shares in GDP of the public debt and budget deficit - these indicators in recent years (for the 2006 moment) are well below the thresholds set by the Maastricht Treaty"(National Bank of Romania - Annual Report 2006). However, despite the steady reduction of the inflation rate in the period 2000-2006, the annual average inflation rate in 2006 was 3.76 percentage points above the benchmark criterion. In terms of long-term interest the t-bonds with maturity of 10 years issued in August 2005 had 7.49% interest rate with 1.29 percentage points higher than the criterion and the exchange rate of the RON against the euro in 2005 -2006 had a margin of variation of +10%/-6,1% from the average of two years development is considered within the range of ERM II standard fluctuation.

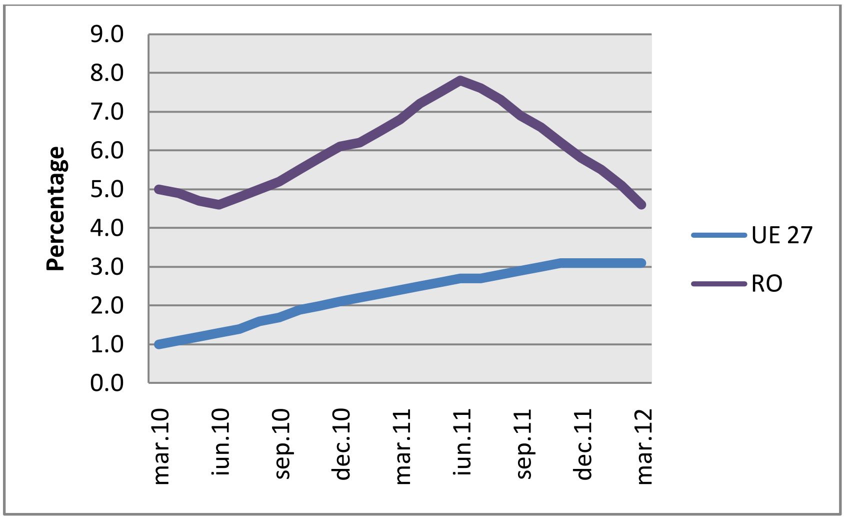
The positive economic developments in all European economies and Romania created optimism, not justified in our opinion, about Romania's ability to enter ERM II in 2012 and maintain the long term exchange rate stability followed by meeting all criteria of nominal convergence. In reality the fact that even in conditions of economic stability that began to characterize the Romanian economy in 2006 – 2007 it was difficult to approach the criteria should there be a warning sign in terms of achieving the nominal convergence and the situation was similar for other countries in process of accession to the Euro zone.

Generally speaking, prior to the financial crises, in most candidate countries, the inflation pressure was growing. Poland and Slovakia were the only new member states which recently have recorded a better inflation level (National Bank of Romania – Annual Report 2010)

The average annual inflation rate in Romania has dropped steadily during the period 2000-2007, up to values of about 4.5% in the secondhalf of 2007. During this period, inflation in the euro area remained around 2%. Since the second half of 2007 and during the first three quarters of next year, the inflation rate in Romania rose continuously, reaching 7.9% in September 2008. The determinants of that evolution have been: the increasing international prices of raw materials, the persistent surplus demand, the gap between wage growth and the labor productivity and a significant currency depreciation. In 2009 in condition of favorable agricultural production dynamic stabilization and administered prices, the annual average inflation rate in Romania fell by about 2.3%, while continuing to record a substantial gap (4.5%) than the reference value of the criterion on price stability. During 2010 a number of factors recorded significant inflationary pressures: increases in administered prices, continuing the series of increases in tobacco taxes, constraints arising mainly in the supply goods market, increasing the standard VAT rate by 5% (with effect from July 1st), and increased raw material quotations on the international markets. Thus, in 2010, the average annual inflation rate was 6.1%, the difference from reference level being 3.7%.

In April 2011 the inflation rate in Romania was 7.2% and the difference between this value and the reference value of the criterion rose at 4.3%.

Figure 1 - Annual average rate of Harmonised Index of Consumer Price



Source: National Bank of Romania data series and EUROSTAT

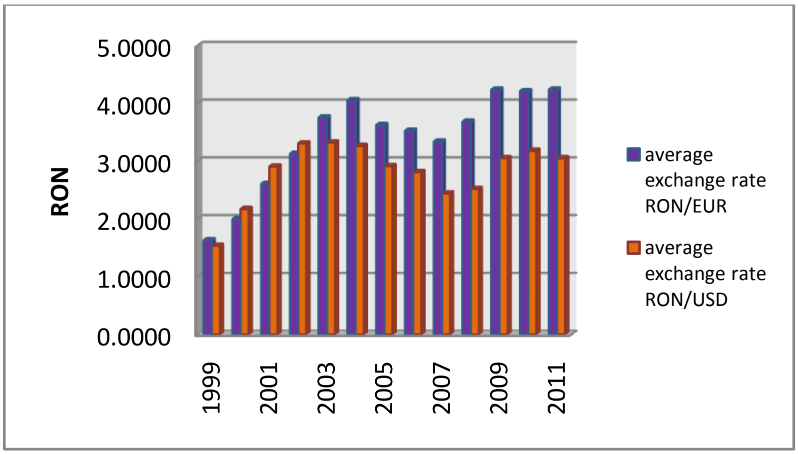
In the last three years, the share of the consolidated budget deficit to GDP has exceeded the limit imposed by the Maastricht Treaty. Thus, in July 2009, the ECOFIN Council adopted a decision having as object triggering the excessive deficit procedure for Romania and made recommendations for its correction. The compliance with commitments under international financing agreements between Romania and the international financial institutions initiated during 2009 and continued the next year involved substantial fiscal consolidation measures, both in revenues and budget expenditures (National Bank of Romania – Annual Report 2010).

The Government will maintain the policy of fiscal consolidation in line with the commitments under the new agreement with international institutions signed early 2011 and the Convergence Programme for 2011-2014, meeting the needs to close the excessive deficit procedure in 2012.

The second indicator of the sustainability of public finances (the ratio of government debt to GDP) has deteriorated compared to 2009 but its value at the end of 2010 still respecting a substantial margin comparing with the nominal criterion.

Since the second half of 2007 amid global financial crisis and the deterioration process of the foreign investors' perception on the Romanian economy and on the risks associated with the Central and Eastern Europe economies, the national currency depreciated significantly against the euro. The evolution of currency exchange rate can be characterized as having moderate volatility. Thus, from 2009-2010, the variation of currency exchange rate against the euro was not exceeded the standard band of ± 15% from the benchmark.

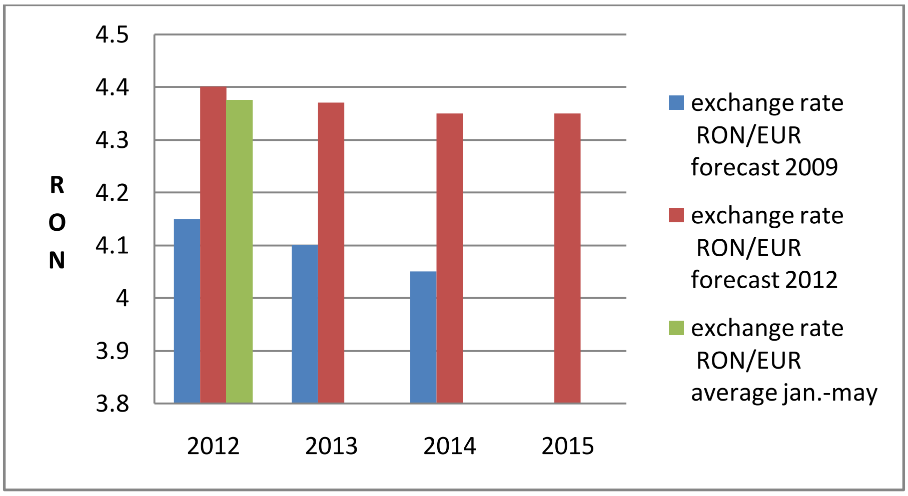
Figure 2 - Annual average of RON exchange rate



Source: National Bank of Romania data series

In the autumn of 2009 the National Commission of Forecasting in Romania estimated that the national currency will appreciate slightly against the euro and U.S. dollar but in spring 2012 forecast revision was made to dampen it. Even so, forecasts for 2012 are exceeded by actual developments on the currency market like the figure no.3 shows.

Figure 3 - Exchange rate RON/EUR forecast

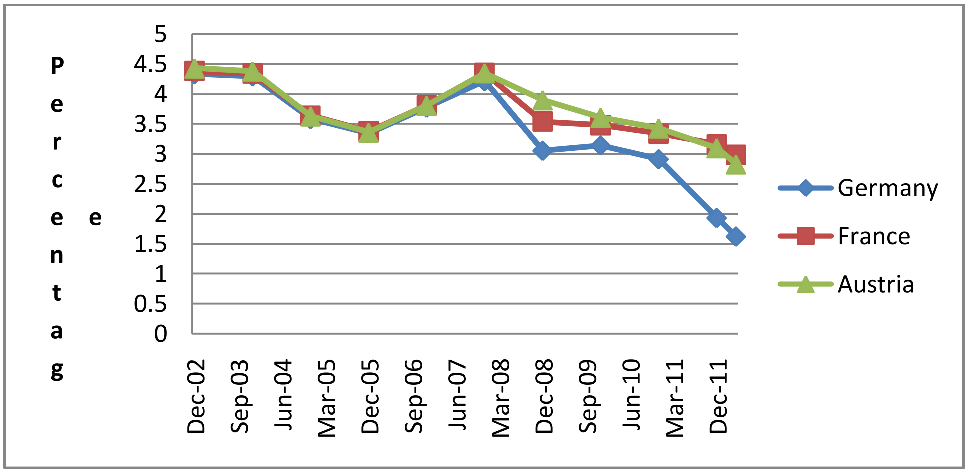


Source: National Commission of Forecasting, National Bank of Romania

The cost of the long-term borrowing (measured by the long-term interest rate) was, in last three years, higher than the benchmark, the maximum spread is recorded in 2009 (3.7%). In 2010, the gap was 2.1% and has reduced to 0.3% in April 2011.

Comparing the long-term interest rate in European Union countries we find three different situations as shown in following three graphs.

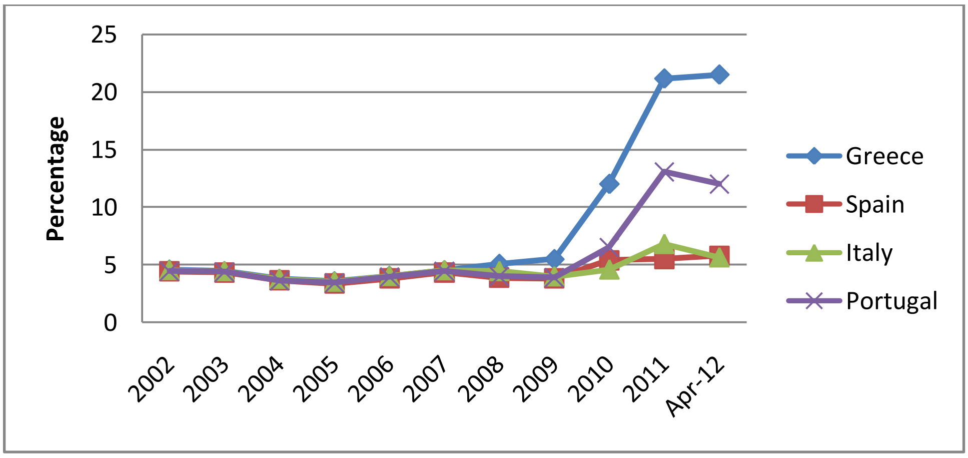
Figure 4 - Harmonised long-term interest rates for convergence assessment purposes



Source: European Central Bank statistics

Following the evolution of the long-term interest rate in three euro area countries that have implemented anti-crisis programs with positive effects on the evolution of the national economies we find that after a peak in 2007 this long term interest rate has declined steadily until 2012 as shown in Figure 4.

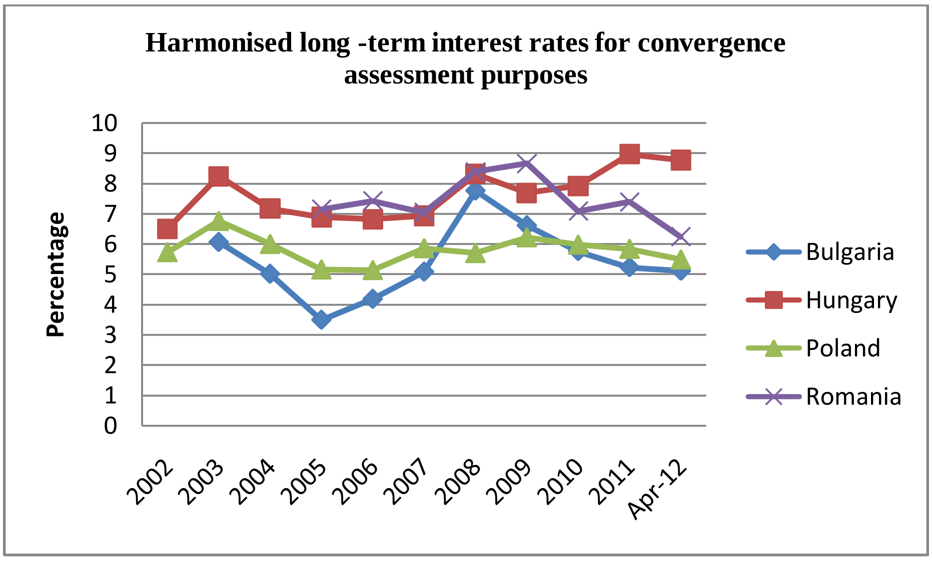
Figure 5 - Harmonised long-term interest rates for convergence assessment purposes



Source: European Central Bank statistics

On the other hand, analyzing the evolution of the cost of borrow in euro area countries facing a deepening of the financial and economic crisis in the last three years it's been a dramatic increase especially for Greece and Portugal. If Portugal has exceeded 10% in 2011 Greece passed in 2011 by the 20% as showed in Figure 5.

Figure 6 - Harmonised long -term interest rates for convergence assessment purposes



Source: European Central Bank statistics

Considering the countries of Central and Eastern Europe which were enrolled in the process of adopting the euro after joining the European Union we find that, although affected by the global financial crisis they did no dramatic changes to the long-term interest rate securities government with a maturity of 10 years proving themselves more attractive financial on the markets than the other group. Of the four countries considered in Figure 6 we notice that only one has seen an increase in this indicator is Hungary, the other 3, Romania, Poland and Bulgaria, have registered a decrease slightly after 2009.

Table 1 - Maastricht Criteria for Romania before and after the crisis

			Romania					
Indicators of nominal convergence	Level of the Maastricht Criteria	How it is measured	2006	2007	2008	2009	2010	April 2011
Inflation rate (HICP*)	Not more than 1.5% above the rate of the 3 best performing Member States	Inflation rate	6.56	4.9	7.9	5.5	6.1	7.2
		Maastricht Criteria (%)	2.8†	2.8	4	1.1	2.4	2.9
Sound public finances‡	Reference value: not more than 3%	Government deficit as % of GDP	1.9	2.5	5.4	8.3	6.4	-
Sustainable public finances	Reference value: not more than 60%	Government debt as % of GDP	12.4	13	13.6	23.7	30.8	-
Exchange rate stability (maximum % of appreciation/ depreciation for 2 years §)	+/- 15%	Participation in ERM II for at least 2 years without severe tensions (%)	+10/ -6.1	+10.8/ -9.6	+9.7/ -14.6	+1.6/ -18.7	…/ -10.4**	-
Durability of convergence	Not more than 2% above the rate of the 3 best performing Member States in terms of price stability	Long-term interest rate	7.49	7.1	7.7	9.7	7.3	7.1
		Maastricht Criteria (%)	6.2††	6.4‡‡	6.2	6	5.2	6.8

Source: Annual Report of NBR – 2006, 2007, 2008, 2009, 2009, 2010, EUROSTAT, National Institute of Statistics, authors estimations

2. THE REAL CONVERGENCE OF THE ROMANIAN ECONOMY

Although the real convergence criteria are not specified in the Maastricht Treaty and are not specifically tracked by the European Commission, they have a high predictive content in terms of the success by adopting a common currency, and achievement of a favorable report between benefits and costs. The single monetary policy, developed by the European Central Bank cannot and should not cover features of each economy, it addressing a supposedly homogenous group of economies that reached prior to accession a real convergence.

In this context, the premature abandonment of its national monetary policy by a country with still an insufficiently restructured economy can generate more costs than benefits. For this reason,

* the Harmonized Index of Consumer Price

† According to ECB Convergence report Conform, December 2006

‡ According to ESA 95 methodology

§ It has been taken into account the maximum appreciation/depreciation for the period of 24 months of the national currency exchange rate comparing with the average exchange rate for the month prior to the period considered.

** Maximum percentage deviations of the exchange rate against the euro for the period January 1st 2009 - December 31st 2010. Calculations are performed in series with daily frequency and reported to December 2008. In the reference period were not recorded positive deviations compared to the average exchange rate of December 2008.

†† According to ECB Convergence report Conform, December 2006

‡‡ According to ECB Convergence report Conform, December 2006

policy makers should pay attention to real convergence criteria. Meeting these real convergence criteria ensure a high degree of cohesion for member state ‘economies of a monetary union. The main real convergence criteria are:

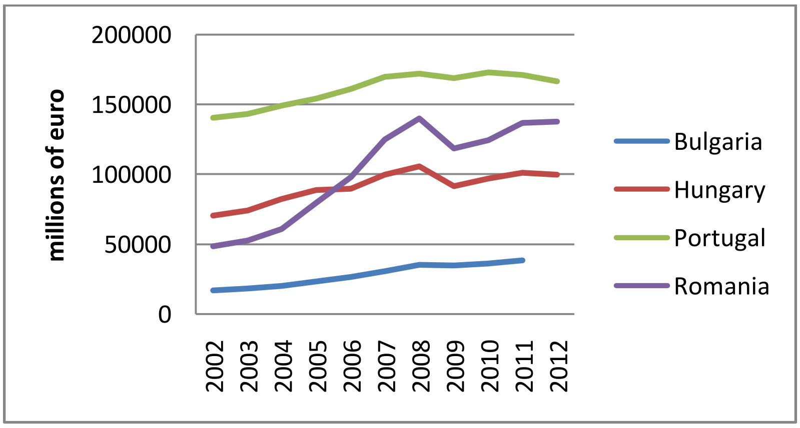
- GDP / capita, both nominal and purchasing power parity;
- Structure of economic sectors;
- Openness of the economy;
- The share of EU trade in total foreign trade.

In terms of GDP per capita Romania has made a significant progress over the past 11 years increasing from 20% in the euro area in 2001 to 43% in 2008 and then a slight decrease from 40.6% in the euro area year 2010.

Analyzing the gross domestic product for the 27 EU member countries and comparing with Romania, Bulgaria, Hungary and Portugal is seems that there is a very big difference between the values of this indicator for two situations: the Union and the euro zone's values are incomparable higher and on the other hand, including in the comparison Portugal, which in terms of nominal convergence criteria is exceeded by Romania and Bulgaria in terms of long-term interest rate, we find that in terms of a criterion real convergence Romania, Bulgaria and Hungary have recorded much lower values.

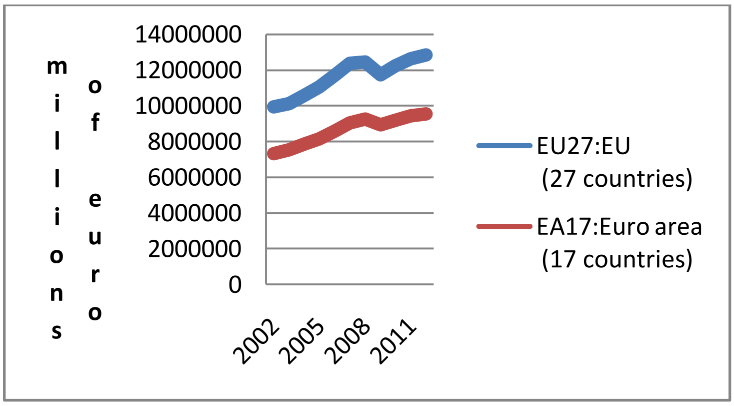
This shows that in order to correctly assess the ability of a candidate country into the euro area we cannot ignore its ability to achieve real convergence. Moreover, in our opinion, it would be dangerous for a country to meet the nominal convergence criteria only because the euro introduction will grow that economy’s vulnerability if not fulfill the real convergence too.

Figure 7 - Gross domestic product at market prices



Source: EUROSTAT database

Figure 8 - Gross domestic product at market prices



Source: EUROSTAT database

The sectorial structure of the national economy during 2000 - 2010 was convergent with the euro area representing a guarantee of the possibility of shock attenuation.

The openness of the economy recovered in 2010 to over 75%, after a minimum in the last 10 years of 67.6% in 2009. Integration in terms of trade with the European Union, quantified by the share of trade with other EU countries in total foreign trade of Romania remained at a high level of over 70% in 2010.

Until the end of 2006, the necessary financing current account deficit was covered in a high proportion by the net FDI inflows, the majority share being provided by the privatization operations and the profits reinvesting process.

The situation has significantly changed since 2007, mainly because the deficit through the foreign direct investment stood at lower levels, up around 50%, initially as a result of substantial growth of the current account deficit then as a result of the massive reduction of the capital inflows determined by the propagation of international crisis on the Romanian economy.

CONCLUSIONS

In conclusion we can say that the analysis proves, in our opinion, two things:

- On the one hand both before the start of the international financial crisis in 2007 and in the next period the Romanian economy could not meet the convergence criteria in their entirety and the unfavorable conditions have affected the two indicators which fit in the benchmark values;

- On the other hand, in the context of a high uncertainty on the future of the euro but also the real convergence that Romania fails to reach should slow the Euro adoption process taking the example of the states that are also in the process of accession, more likely to fulfill criteria of nominal convergence and certainly a more solid real convergence as Poland and which were delayed this decision for 2020.

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