Bulletin of the *Transilvania* University of Braşov • Vol. 6 (55) •No. 1 - 2013
Series V: Economic Sciences

ADOPTING THE EURO: ROMANIAN PERSPECTIVES IN THE CONTEXT OF THE GLOBAL FINANCIAL CRISIS

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Abstract: *The objective of this paper is to examine Romania's capacity to fulfil the nominal convergence criteria in the current context, in order to follow the calendar proposed for euro adoption in 2015. The paper analyzed the evolution of all five criteria under the impact of the current financial crisis and also looked at the forecast provided by national and international authorities. The study was conducted considering the relative situation with the euro area. The main finding is that the actual target for euro adoption could be complied with, provided further progress is made. We have also fond that the target should be achieved as it would represent a strong stimulus for the local government to implement additional measures to reduce public indebtedness and inflationary pressure.*

Key words: *Romania, Euro, nominal convergence criteria, financial crisis.*

1. Introduction

The euro area is a unique model of economic and monetary union: it comprises 17 European Union member states, most of them different as regards economic development, political system, culture and mentality, but who decided to adopt the euro as a common currency and legal tender. As Mundell (1961) stated in his seminal paper, "supra-money", a concept which was debated a long time, finally came into existence. (Mundell, 1961).

Based on the gross domestic product (GDP) and population, the Eurozone is a leading global player in the world economy. As noticed in Table 1, in 2011 the euro area was the second largest economic entity in the world after the United States, but well beyond China. The euro has also become the second most widely used international currency, with a rising share in foreign exchange reserves from 17.9% in 1999 to a peak of 27.7% in 2009, and to 25% in 2011.

Looking at the data presented above, we could conclude that it is a tremendous privilege to join such a "club". However, is it possible for Romania to adopt the euro in 2015 as originally planned? Did the current financial crisis affect the attainment of the nominal convergence criteria? Is it Romania still "on track"? These are the questions we will try to answer in the following chapters. The paper is structured as follows. Chapter 2 presents the advantages and disadvantages of adopting the single currency and also options for Romania. Chapter 3 analyzes the evolution of the five nominal convergence criteria

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under the impact of the current financial crisis and also looks at the forecast provided by national and international authorities. Chapter 4 presents the concluding remarks.

Main characteristics of the world's most important economies (2011) Table 1

	Population (millions inhabitants)	Total GDP (billions of dollars, current prices)
EU27	**503**	**17.574**
Euro area	**332**	**13.079**
USA	**311**	**14.991**
Japan	**127**	**5.867**
China	**1344**	**7.318**

Source: World Bank

2. Advantages, disadvantages and options of euro adoption

Indeed, as stated before, entering the Eurozone offers a series of advantages, as it:

- Eliminates the foreign exchange risk with the euro and significantly reduces the foreign exchange risk in relation to other currencies, with multiple effects upon foreign trade;
- Reduces transaction and administrative costs:
- Reduces the cost of capital by lowering interest rates, which further encourages foreign direct investments and promotes long-term economic growth:
- Increases price competition and transparency.

On the other hand, adopting the euro as a national currency also implies a series of costs and disadvantages. First, there are technical costs, related to the physical conversion to the euro, and also costs for the banking sector. But one of the most important drawbacks of euro adoption is the loss of independent monetary policy, which will be transferred to the European Central Bank. This implies the loss of ability to depreciate the currency in periods of recession, and thus the possibility to become uncompetitive, as it happened to Greece, Portugal and other European countries hit by the recent financial crisis.

However, adopting the euro as a single currency is not an option, but a commitment. [1] All EU member states that are not in the euro area are required to make the necessary adjustment to fulfil nominal convergence criteria. According to the Maastricht Treaty, every candidate intending to join the euro area has to achieve several nominal convergence criteria. 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.

Since 2007, Romania has begun the process of accomplishing the nominal convergence criteria, but after five years, further efforts are required in order to adopt the single currency, especially related to public indebtedness and the evolution of the inflation rate. Romania has set 2015 as the date of the accession to the Euro area, but opinions of the policymakers, the monetary policy decision makers and economists do not converge. While the President fixed the target for 2015, the Prime Minister claims the deadline is not „cast in stone”, the Romanian National Bank believes that this horizon should not be forced, while some economists believe that, given the current political and economic conditions, the accession to the euro should not be a topic of discussion (Duhnea et. All, 2012). The changing of the economic and financial climate in Europe has modified the position of the countries that are in the process of adopting 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, Poland, Hungary and Lithuania currently do not have a target date for the adoption of the euro (ECB Convergence Report, 2011).

3. Is it possible for Romania to adopt the euro in 2015? Some evidence from nominal convergence criteria

Nominal convergence criteria are the only formal conditions an EU member state has to fulfil in order to adopt the single currency. The Maastricht Treaty does not refer to any of the real convergence criteria which ensure the cohesion and a certain degree of similarity between the members’ economic structure. One explanation could be that, at the moment the Treaty was signed, the European Union was (with one or two exceptions) a rich country “club”, with similar economic structures. [2] Although over the recent years, the European Commission and the ECB have given warnings regarding the risks of adopting the euro without fulfilling the real convergence criteria, we will focus our attention on nominal criteria as they are the standard for a future resolution of Romania’s entry into the “euro club”.

In 2007, the year Romania entered the European Union, policymakers and economists were quite optimistic about the possibility of Romania entering the Eurozone no further than 2015. Looking at the data from 2007, most of the indicators were within the limit or very close to it. Romania had a government deficit of 2.5%, which was below the reference value while, the government debt stood well below the 60%, at a modest value of 13%. The exchange rate of the RON against the euro in 2007 had a margin of fluctuation of +10.8%/-9.6% from the average of two years development, which is considered within the range of ERM II standard fluctuation. In terms of the long-term interest, the average was 7.1%, an interest rate which was 1.29 percentage points higher than the criterion, but the difference was not particularly high. The biggest issue of the Romanian economy was the inflation rate. Although looking back over a longer period, the annual consumer price inflation in Romania decreased from extremely high levels in the early 2000’s until 2007, the value of 4.9% exceeded the standard by over 2 percentage points.

Table 1

Nominal convergence indicator	**Maastricht criteria**	**ROMANIA**				
		2007	**2011**	**May 2012**	**2015 (Romanian Government est.)**	**2015 (IMF est.)**
Inflation rate (%, annual avg.)	<1.5 pp above the avg of the 3 best-performing states	4.9 (criterion 2.8)	5.8 (criterion 3.1)	3.5 (criterion 3.1)	**2.5 +/-1** (criterion 2.59)[2]	**2.9**
Government deficit (% of GDP)	below 3 percent	2.5	5.2	2.8[1]	**0.9**	**0.5**
Government debt (% of GDP)	below 60%	13.0	33.3	34.2[1]	**31.8**	**32.9**
Exchange rate vs euro (2-year maximum percentage change)	+/- 15%	+10.8/-9.6	+3.9/-3.3	+2.5/-6.5	**…**	**…**
Long term interest rate (% per annum, annual avg.)	<2 pp above the avg of the 3 best-performing states in terms of price stability	7.1 (criterion 6.4)	7.3 (criterion 5.8)	7.1 (criterion 4.0)	**…**	**…**

[1]Government of Romania estimate

[2]Own calculations based on IMF Staff estimates; reference countries are Greece, Belgium and Italy

Source: National Bank of Romania, Annual Report 2007 and 2011; Government of Romania Convergence Programme 2012-2015

3.1. Price stability

Looking at the evolution of the inflation rate between 2007 and 2012 (figure 1), we can detect two periods of relative high inflation and significant spread between the local interest rate and the one in the Eurozone. The rising inflation that characterized the period 2007-2008 can be viewed as the outcome of an overheating economy, with wage growth significantly outpacing productivity growth, which in turn drove unit labour cost growth to unusually high levels. In 2009, inflation fell and broadly stabilized afterwards at about 6%, as the economic activity sharply contracted. Still, the gap with the euro area remained significant. In 2010, the inflation rate rose again, due to a sharp increase in the price of international commodity, as well as to 5 percentage point pick-up in the standard VAT tax starting on 1 July 2010. In the second part of 2011 and during the first five months of 2012, in Romania, inflation developments led to the considerable decline in the spread between the two values, thanks to the favourable impact coming from the fading-out effect of VAT increase as well as from easing pressures from energy and food prices owing to international prices and a very good harvest.

The latest available forecasts from IMF project inflation to rise in 2012-13 from historically low levels of 3% on average in 2012 to 3.2% in 2013, and then again a decrees to 2.9 in 2015. According to my own calculations, based on IMF estimates, in 2015 the reference criterion will be 2.59, so in this case Romania will not meet this criterion. However, there are upside risks, related mainly to the dynamics of commodity and administered prices, the latter on the medium term. Looking further ahead, the catching-up process is likely to have an important influence on inflation over the coming years as the GDP per capita and price levels are still significantly lower in Romania than in the euro area. However, it is difficult to determine the exact magnitude of the effect resulting from this catching-up process.

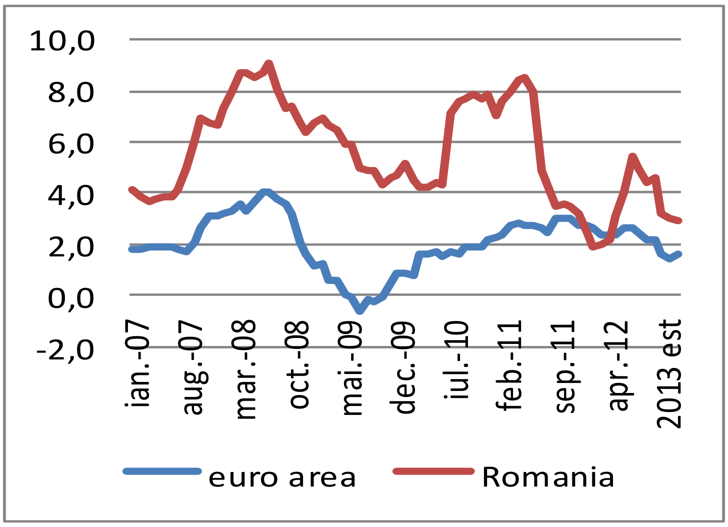


Fig. 1. *Inflation rate (HICP)*

3.2. Sustainable public finance

3.2.1. Government deficit

Before the current financial crisis, Romania, unlike other EU member candidates, had a very good performance regarding public finance indicators. The government deficit, as well as the government debt, was comfortably below the reference values, which was considered a significant advantage, as these issues require the most painful adjustments.

As noticed from figure 2, since 2008, the share of Romania's general government deficit in GDP exceeded the maximum stipulated by the Maastricht Treaty, peaking over 8% in 2009. Under the pressure that came from the international financial institutions through external financing agreements, Romania took some fiscal consolidation and managed to reduce the government deficit to 5.2 percent of the GDP by end-2011. ((The National Bank of Romania, Annual Report 2011)

As decided in the EU-IMF financial assistance scheme, Romania is on track to reduce the budget deficit below the 3% reference value in 2012 and beyond. The estimates presented in the Convergence Programme 2012-2015 suggest that the deficit will drop to 0.5% by 2015 while IMF estimates a deficit level of 0.9% in 2015.

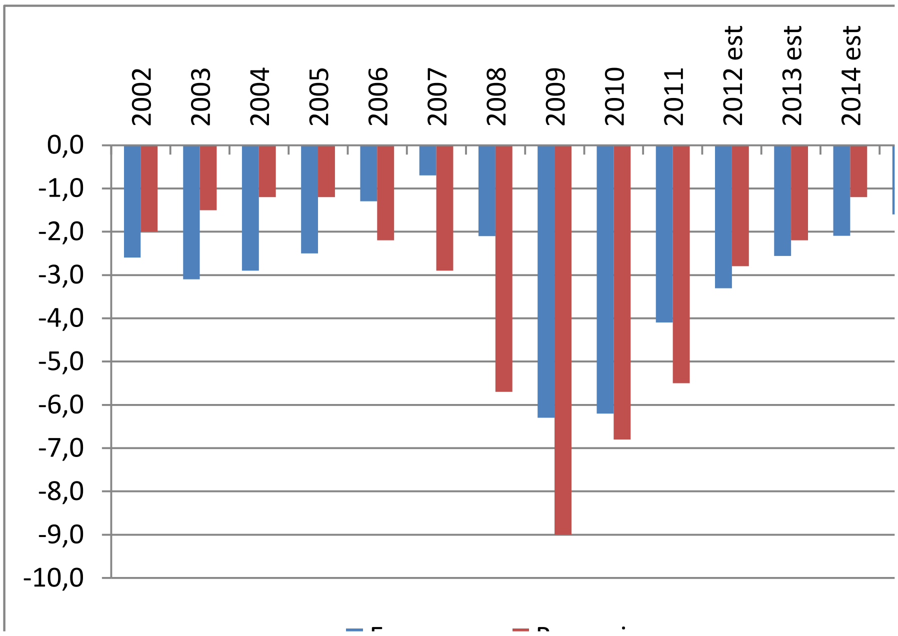


Fig. 2. *General Government deficit (% of GDP)*

3.2.2. Government debt

The second measure of public finance sustainability, the government debt, is one criterion which has been below the reference value since Romania entered the European Union. The current financial crisis had a negative impact on the government debt, which rose from 13% in 2007 to 23% in 2009 and continued to grow to over 30% in 2010-2012. Despite all this, it continued to display a level by far lower than the limitation set forth by the nominal criterion. Moreover, Romania is situated well below the EU debt average, having a better position when compared to more developed countries like Germany or France, but similar debt values with other candidates like Lithuania or Latvia (see figure 3). Projections provided by Romanian authorities and IMF show only a slightly reduction in government debt, to 31,8%, respectively 32.9 % by 2015.

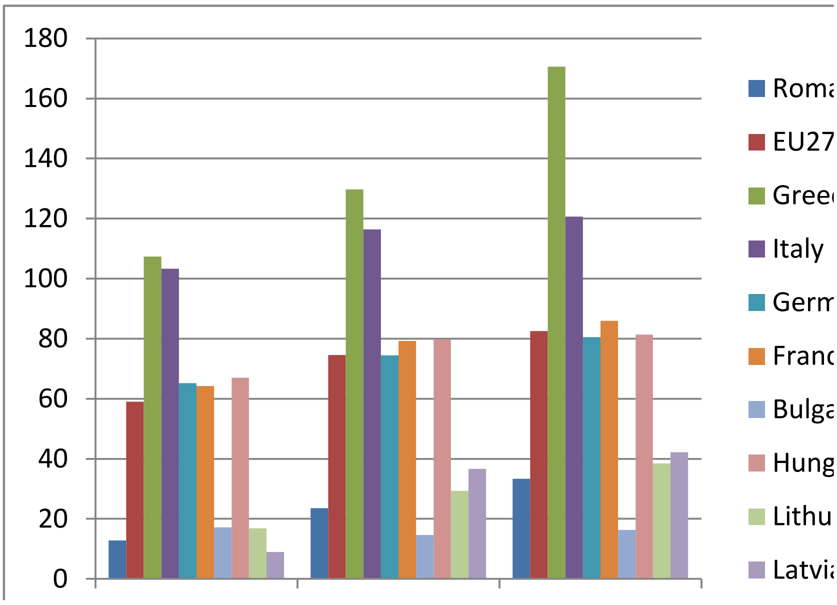


Fig. 3. *General Government debt (% of GDP)*

3.3. Long term interest rates

The long-term interest rate has always been a problematic issue and continued to exceed the reference level. Before the current financial crisis, the spread between long term interest rates in Romania and euro area was under 1%. Since 2008, though, the upward trend of local interest rates sharply intensified against the backdrop of deterioration in economic activity, as well as owning to an increase in the monetary policy interest rate. Tensions in international financial markets led to high volatility of the long term interest rate, which reached its peak in July 2009 at 11.46% (see figure 4). Since then, long-term interest rates were subsequently placed on a downward trend, supported by easing inflationary pressures and a reduction in the monetary policy rate, reaching a low of 6.7% in January 2011, shortly before the expiration of the multilateral adjustment programme. (ECB Convergence Report, May 2012)

During the current financial turmoil, simultaneously with changes in the inflation differential between Romania and the euro area, the long-term interest rate differential also increased from the second half of 2007 until the summer of 2009, peaking at 7.7 percentage points in August 2009. As estimated by Romanian authorities, although the long-term interest rates were also on a downward trend, the spread widened to 3.1 percentage points in May 2012, as a result of the drop in the reference level.

In the future, policymakers and the Central Bank believe that the downward trend will continue as the disinflation process will consolidate, and economic operators will be convinced by its sustainability.

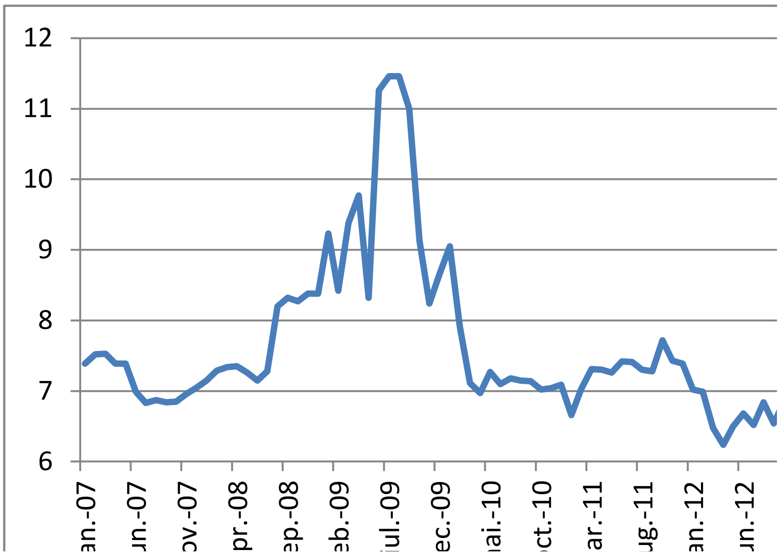
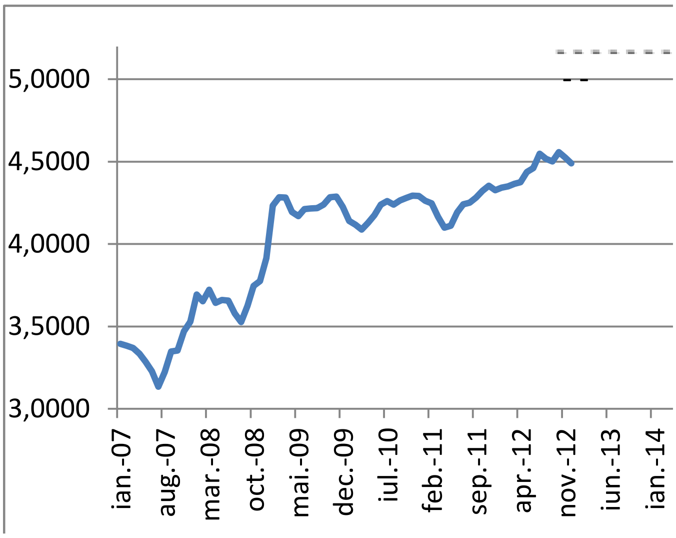


Fig. 4. *Long term interest rates in Romania (% per annum, annual avg.)*

3.4. Exchange rate stability

The Romanian leu has not yet joined ERM II, thus for the last two years traded under a flexible exchange rate regime. Since mid-2007 until early 2009, the leu depreciated markedly versus the euro against the background of the deterioration of the foreign investors' perception on the risks associated with Central and Eastern European economies. After the Romanian Government signed agreements with the international financial institutions in 2009 and the financial tensions in the region alleviated, the evolution of the leu exchange rate versus the euro became relatively stable. Between December 2010 and December 2012, the leu-euro exchange rate depreciated from 4.29 to 4.49, or by 4.6%, its fluctuations falling within the ±15 percent standard band compared to the reference level (The National Bank of Romania Annual Report 2011).

In autumn 2012, the National Commission of Forecasting in Romania estimated that the national currency will reach the level of 4.5lei/EUR in 2013, and then it will appreciate to 4.45 in 2014 and 4.4 in 2015. If so, the exchange rate will not exceed the standard band.



**The dotted lines represent the limit of the +/-15% band versus the average exchange rate for December 2012*

Fig. 5. *RON-EURO Exchange rate (monthly avg)*

4. Conclusions and future prospects

The current financial crisis had a serious impact on Romania's possibility to accomplish the nominal convergence criteria. If in 2007, 3 out of 5 criteria were below the reference value, while another one was relatively close to the reference value (long term interest rates), in 2011 only 2 criteria were met, while the other 3 were severely deteriorated. In order to adopt the euro, radical improvements regarding nominal convergence criteria are still required. Still, projections made by local authorities, as well as international financial institutions (IMF) suggest that Romania will be able to fulfil all 5 criteria by 2015. Analyzing the data, we consider that the present target for euro adoption could be complied with, provided further progresses are made regarding the inflation rate reduction. I also consider that the target should be achieved, as it would represent a strong stimulus for the local government to implement further measures to alleviate public indebtedness and to reduce inflationary pressure**.**

Notes

1] UK and Denmark are exceptions, as they negotiated „opt-out" facilities. Sweden creates a precedent, as it has no such facility, but it has not yet adopted the euro, because it has not made the required changes to central bank legislation.

2] Isarescu, M. (2007), Romania, drumul catre euro (Romania, the road to euro), Paper presented in the Conference organized by the Academic Colege of „Babeş-Bolyai", Cluj Napoca, 2004 (updated version March 2007)

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