Romanian Policy-Mix to Adopting Euro

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Abstract. *This paper evaluates the present estate of Euro implementation in Monetary and Economic Union (EMU) and Romanian position in this context. The Romanian admittance in EU at January 2007 increased the interest to study the transmission and coordination mechanisms, related to mix common monetary policy – different fiscal policy across the countries in the Euro area. Our study focuses on the consequences of Romanian admittance in Euro Zone in 2014 and optimal policy-mix to good preparation to accomplish this target. The controversies between economists regarding the construction process of EMU remain large. What are the consequences of implementing the "tye-hands" strategy for Romanian financial authorities? Can Romania solve the potential conflict between real and nominal convergence relating the European integration? What is the best strategy for Romania with the aim to obtain a faster real convergence with the European Union countries? Can Romania maximize the benefits to adopting Euro in 2014?*

Key words: optimum currency area; costs; benefits; European Monetary Union; euro; convergence.

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For Romania, the completion of a seven-year interval of preparations (2000-2006) for the EU accession and the start of another interval of preparations (2007-2013) for the adoption of the Euro currency, which has approximately the same duration, is a significant opportunity to continue the reforms and to reduce regional economic disparities. Improvements concerning real convergence must be made in such a manner not to affect the nominal convergence criteria that are by maintaining macroeconomic equilibrium.

Since 2000 the Romanian economy has recorded steady growth, averaging an impressive 5.7% per year. 2006 marked a further acceleration – real GDP growth is expected to be 7.8 % on the back of robust private consumption spending and accelerating investments, and boosted by post-flood reconstruction activity. Growth prospects remain positive over the medium term on the back of EU membership, despite a gradual slowdown due to lowering consumption. Investment is expected to remain the fastest growing component stimulated by the sustained inflow of FDI, the channelling of additional budget resources and the unfolding of a larger number of infrastructure programs co-financed by the EU. Looking forward, the Romanian government recently presented its convergence report outlining plans to enter ERM II in 2012. On this respect, further efforts are still needed in order to forge ahead with the disinflationary process and achieve fast convergence in interest rates to meet all criteria as of Q4 2011 and adopt Euro as of 1 January 2014. Further progress is also needed in order to improve the predictability of fiscal policy, properly manage EU funds and further modernize the public sector to avoid the activation of safeguard clauses and ensure full compliance with EU standards (Unicredit Romania, 2007).

The nominal convergence process is obtained faster than real convergence. There is a consensus among policymakers regarding the correlation real convergence – nominal convergence. In fact, a higher degree of real convergence represents the substance of successful integration in European model.

First, we analyze the level of achievement of nominal convergence criteria for Romanian economy. For 2007, the inflation target was set at 4% dec.-on-dec. with a tolerance band of one percentage point in either direction; for 2008, the central target will become 3.8% dec.-on-dec., with the same margin of tolerance, and, over the medium term, the inflation targets will be set in accordance with the path necessary for maintaining the disinflation process consistent with the convergence criteria. Although relatively modest from a comparative perspective, the Romanian performances and track-record regarding the reduction of the inflation rate, improved in the last several years-especially after 2000.

Inflation rate (CPI) – 2001-2006

Table 1

	2001	2002	2003	2004	2005	2006
Annual average rate	34.5	22.5	15.3	11.9	9.0	6.6
End of the period	30.3	17.8	14.1	9.3	8.6	4.87

Source: National Bank of Romania, 2007.

At the end of 2006, the year on year inflation rate declined to a historical minimum level of 4.87%, with a more obvious deceleration in April, due to a base effect, and also in July and September, when quarterly changes in CORE1 inflation highlighted a clear slowdown in the pace of price increases. The more intense disinflation process was the result of an appropriate monetary and fiscal policy mix, improved market expectations regarding the sustainability of the disinflation process and increased competition in the retail sector (NBR, Inflation report, 2007 february).

Regarding the specific medium-term objective, Romanian Government targets the structural deficit at the level of 0.9% of GDP by 2011. This level provides a satisfactory safety margin to prevent breaching the budget deficit ceiling of 3% of GDP in the presence of possible future adverse shocks to the rate of economic growth.

Reaching this goal and covering the additional expenditures related to the EU accession process would mean an increase of the budgetary expenditures' percentage from approximately 33% of the GDP in 2005, up to 39% of GDP in 2009, rates higher than those of Ireland and Lithuania, but lower than of all other 24 European countries. The budgetary policy framework in 2007 will remain prudent on the expenditure side, targeting a balance between supporting the macroeconomic framework through the continuation of the disinflation process and keeping the current account deficit within sustainable limits, and by promoting priority investment projects.

The key objectives of the budgetary policy are reasserting the public policies in the areas related to the human capital, as education, research and development, health and social cohesion, while financing the national contribution to investment programmes eligible for EU funds and sustaining the payment of the national contribution to the EU budget (Ministry of Finance, Convergence Programme, 2007).

To growth real convergence with the European model, the medium-term fiscal framework reflects the necessity to consolidate the revenues by improving tax collection and by broadening the tax base, in the purpose to accommodate the increased government spending commitments. Further revenue consolidation and increasing public spending in key areas such as education, R&D, transport and environment infrastructure becomes compulsory in the light of the economic competitiveness needs of the Romanian economy. The actual medium term expenditure framework creates sufficient fiscal space to accommodate accession related costs (including our contribution to the EU budget) and to sustain our commitments from the perspective of the EU Lisbon agenda.

The public debt ratio of Romania is below 20% of GDP, much lower than the threshold of 60% of GDP set by the Maastricht Treaty. At the end of 2005, the government debt, calculated in accordance with the EU methodology (ESA95), represented 15.9% of GDP, out of which the domestic debt was 3.2% and the foreign debt was 12.7%. For the end of 2006 the level of this indicator is estimated at 12.8% of GDP.

Public Deficit (-) / Surplus (+) (% toGDP)

Table 2

Countries/Years	2003	2004	2005	2006	2007 (estimation)
Bulgaria	0.3	1.9	3.1	3.7	2.0
Czech Republic	-6.6	-2.9	-2.6	-3.8	-4.6
Poland	-4.7	-3.9	-2.5	-1.7	-3.6
Romania	-1.7	-1.3	-0.4	-1.8	-2.8
Hungary	-6.4	-5.4	-6.1	-9.8	-6.8
EU-15/EU-27	-3.0	-2.6	-2.3	-2.3	-2.2

Source: EUROSTAT, National Banks, 2007.

Public debt (% to GDP)

Table 3

Countries/Years	2003	2004	2005	2006	2007 (estimation)
Bulgaria	46.1	38.6	29.9	26.7	28.2
Czech Republic	30.0	30.6	30.5	31.5	33.2
Poland	43.9	41.9	42.5	45.5	46.8
Romania	20.7	18.0	15.2	12.8	18.2
Hungary	56.7	57.1	58.4	59.9	62.2
EU-15/EU-27	62.0	62.4	63.4	63.2	63.0

Source: EUROSTAT, National Banks, 2007.

Regarding the initial maturity of government debt, 6.4% is short-term debt, while 93.6% is medium and long term, the average maturity being 5.6 years. The local currency debt represented 19.1% of the total debt, and the government debt denominated in euro was 51.5% out of total hard currency debt.

Secondly, we focused to the Romanian real convergence with the European model. Romanian must continuing and deepening the structural reforms and delivering improved public services in health, education and professional formation, research and development and transportation as well as implementing the necessary reforms to enhance accountability and efficiency.

The Romanian economy real convergence with European model can be analyzed starting to GDP per capita at purchasing parity power. In 2006, GDP per capita in Romania was 34% relative to the EU27 average, less than Czech Republic (75%), Poland (51%), Hungary (63%), Slovenia (83%), but more than Bulgaria (33%).

GDP per capita at purchasing power parity (PPP) (EU 27 average = 100)

Table 4

Country/Years	2003	2004	2005	2006	2007 (estimation)	2008 (estimation)
Bulgaria	29.7	30.6	32.1	33.3	35.5	37.0
Czech Republic	67.8	70.3	73.3	75.0	78.1	80.0
Poland	47.0	48.8	49.8	51.0	52.4	53.8
Romania	30.0	32.2	32.9	34.2	37.0	38.4
Hungary	59.3	60.1	61.9	63.2	63.7	64.2
EU-15/EU-27	100	100	100	100	100	100

Source: EUROSTAT, 2007.

The structural convergence index with European economy can grow if the labor productivity will be higher. Then, it drives to the higher incomes, which can sustain economic growth, welfare, etc. If the average rate of labor productivity growth will be 10% annually, then Romanian economy obtain a faster catching up process.

Labor productivity per person employed (GDP at purchasing power parity per person employed person, relative to EU 27 = 100)

Table 5

Country/Years	2003	2004	2005	2006	2007 (estimation)	2008 (estimation)
Bulgaria	31.9	31.7	32.6	33.6	36.3	37.7
Czech Republic	62.0	64.3	68.6	70.4	72.3	73.4
Poland	59.6	62.0	62.7	63.8	60.4	61.9
Romania	34.0	36.3	36.6	37.9	42.5	44.2
Hungary	66.8	68.1	70.1	71.6	73.7	74.5
EU-15/EU-27	100	100	100	100	100	100

Source: EUROSTAT, INSSE, 2007.

Labor productivity growth must be correlated with the business investments growth. In fact, the last indicator shows the measure of private sector investments in economy.

Bussiness investment (as a percentage of GDP)

Table 6

Country/Years	2002	2003	2004	2005	2006 (estimation)
Bulgaria	15.3	16.5	17.7	17.9	18.4
Czech Republic	22.9	22.7	22.6	20.0	24.2
Poland	15.3	14.9	14.6	14.8	16.8
Romania	18.3	18.6	18.6	18.2	19.9
Hungary	18.3	18.8	19.3	18.7	21.4
EU-15/EU-27	17.2	16.9	17.1	17.4	18.2

Source: EUROSTAT, INSSE, 2007.

In Romania, business investment indicator higher than UE-27 average indicates a great potential to private sector development in the future.

Many structural problems of the Romanian economy can be solved by efficient policy to attract foreign direct investments and a good capacity to European funds absorption (cohesion and structural funds). The growth of the capital stock in the Romanian economy will generate a higher rate of economic growth → the growth of labor productivity and higher incomes → the growth of the labor employment → a faster process regarding structural adjustment in the economy, if the FDI are concentrated in the tertiary sector.

A great opportunity for development Romanian infrastructure is the efficient use of European Funds. Since 1st January 2007, Romanian authorities must spend 9 millions Euro per day. In the period 2007-2013, European Union approved for Romania 28 billions Euro cohesion and structural funds. But the Romanian absorption capacity of European structural funds remains weak. During 2000-2005, from ISPA programme Romania spent only 11.6% and from SAPARD programme 43%. In case of cohesion and structural funds, the forecast level for Romania in 2007 is only 4%.

Absorption capacity of European Funds in the period 2000-2006

Table 7

Country	Absorption capacity (% relative to commitments)
Ireland	74
Austria	68
Spain	67
Germany	64
Belgium	58
France	56
Italy	52
Greece	40
Slovenia	28
Latvia	24
Lithuania	24
Hungary	23
Slovakia	23
Poland	20
Czech Republic	18
Bulgaria	7*
Romania	4*

* 2007 estimation.

Source: Eurostat, 2006.

The analysis of Community's directions suggests that financial assistance has positive effects on economic growth at a regional and national level. Cohesion Policy influences all of its sources, contributing to the growth of capital accumulation (through the birth of new firms), of the degree of employment (in concordance with the objectives set by the Lisbon Strategy) and the efficiency with which the production factors are used (education, innovation, reduction of transaction costs). The estimates of the European Commission emphasize an increase in national GDP by 10% as a result of the allocation of financial resources towards the less developed countries of the EU, between the years 2007 and 2013.

Beyond the immediate effects of aggregate demand (income rises in the beneficiary regions), those on aggregate supply become decisive on a long time. Thus, the modernization of the infrastructure, the rise of education levels as well as subsidies of research and development activities permit the increase of potential growth in of the economy (as in potential GDP). In these conditions, shock absorption on the demand or the structural sides will be faster in the countries/regions which benefit from structural and cohesion funds. It results that from cohesion policy, the convergence of business cycles of a economy within Euro zone can rise, consequently increasing the benefits of adopting a single currency.

The fulfillment of the nominal convergence criteria by a certain member country of the EU constitutes a necessary, albeit not sufficient condition to adhere to a monetary union. Essential are the progresses in the process of real convergence, because these are, in a large measure, able to ensure a growth in the economy's flexibility and a higher concordance of business cycles. The adoption of the sole currency implies, beforehand, finding other methods of economical adjustment, as a consequence of the renunciation of the internal monetary policy. Some of these can be the result of structural fund allocation through cohesion policy. Thus, Romania's decision to adhere to Euro zone in 2014, after it would have been able to access the Community's financial assistance in the 2007-2013 periode, is explained.

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