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

Anamaria Laura OROS
PhD student, Faculty of Economic Sciences, “Lucian Blaga” University, Sibiu, Romania
oros.anamaria@yahoo.com

Abstract. The objective of this paper is to investigate Romania`s capacity to fulfill the nominal convergence criteria in the current context, in order respect the calendar proposed for euro adoption in 2015. I analyzed the evolution of all five criteria under the impact of the current financial crisis and I also looked as the forecast provided by national and international authorities. The analysis had been made considering the comparative situation with euro area or with other member states. The main finding is that actual target for euro adoption could be respected, provided further progresses are made and also should be respected, as it would represent a strong stimulus for the local government to implement further measures to alleviate public indebtedness and to reduce inflationary pressure.

Keywords: Romania, Euro, nominal convergence criteria, financial crisis

JEL Classification:

1. Introduction

The euro area is an unique model of economic and monetary union: it is formed of 17 European Union member states\(^1\), very different in 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 long time debated, finally came into existence.\(^2\)

Based on gross domestic product (GDP) and population, Eurozone is a major international player in the world economy. As noticed from Table 1, in 2011 the euro area

\(^1\) Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

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 2011.³

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

<table>
<thead>
<tr>
<th></th>
<th>Population (millions inhabitants)</th>
<th>Total GDP (billions of dollars, current prices)</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU27</td>
<td>503</td>
<td>17.574</td>
</tr>
<tr>
<td>Euro area</td>
<td>332</td>
<td>13.079</td>
</tr>
<tr>
<td>USA</td>
<td>311</td>
<td>14.991</td>
</tr>
<tr>
<td>Japan</td>
<td>127</td>
<td>5.867</td>
</tr>
<tr>
<td>China</td>
<td>1344</td>
<td>7.318</td>
</tr>
</tbody>
</table>

Source: World Bank

Looking at the data presented above, we could conclude that it is an enormous privilege to join such a “club”. But, is it possible for Romania to adopt the euro in 2015, as initially planned? Did the current financial crisis influence the accomplishment of the nominal convergence criteria? Is it Romania still “on track”? These are the questions I 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 the options for Romania. Chapter 3 analyzes the evolution of the five nominal convergence criteria under the impact of the current financial crisis and also looks as the forecast provided by national and international authorities. Chapter 4 presents the concluding remarks and future prospects.

³ IMF, Annual Report 2012 – Working together to support global recovery, Appendix I
2. Advantages, disadvantages and options of euro adoption

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

- Eliminates the foreign exchange risk with the euro and significantly reduces 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 implies also a series of costs and disadvantages. One type of costs is the technical costs, related to the physical conversion to 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.

But, adopting the euro as a single currency is not an option, but an obligation. All EU member states that are not in the euro area are required to make the necessary adjustment to fulfill nominal convergence criteria. 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.

Since 2007, Romania began 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 inflation rate. Romania has set 2015 as the date of the accession to the Euro area and the opinions of the policymakers, the monetary policy decision makers and the economists are not converging: the President fixed the target for 2015, 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

---

4 UK and Denmark are exceptions, as they negotiated „opt-out” facilities. Sweden creates a precedent, as it has no such facility but it had not yet adopted the euro, because it has not made required changes to central bank legislation.
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 and financial climate in Europe 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, Poland, Hungary and Lithuania currently do not have a target date for adoption of the euro (European Commission 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 fulfill 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 members’ economic structure. One explanation could be that, at the moment the Treaty was signed, European Union was (with one or two exceptions) a rich country “club”, with similar economic structures. Although in the late years the European Commission and ECB warn about the risks of adopting the euro without fulfilling the real convergence criteria, I will focus my attention on nominal criteria, as they are the standard for a future decision of Romania’s entrance 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 variation 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 long-term interest the average was 7.1%, an interest rate with 1.29 percentage points higher than the criterion, but the gap was not extremely large. The biggest issue of the Romanian economy was the inflation rate. Although looking back over a longer period, annual consumer price inflation in Romania decreased from very high levels in the early 2000s until 2007, the value of 4.9% exceeded with over 2 percentage points the criterion.

---

5. Isarescu, M. (2007), Romania, drumul catre euro (Romania, the road to euro), Paper presented in the Conference organized by Academic College of „Babeș-Bolyai”, Cluj Napoca, 2004 (updated version March 2007)
Table 2 – Nominal convergence criteria

<table>
<thead>
<tr>
<th>Nominal convergence indicator</th>
<th>Maastricht criteria</th>
<th>ROMANIA</th>
<th>ROMANIA</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflation rate (percent, annual average)</td>
<td>&lt;1.5 pp above the average of the 3 best-performing EU Member States</td>
<td>4.9 (criterion 2.8)</td>
<td>5.8 (criterion 3.1)</td>
</tr>
<tr>
<td>Government deficit (percent of GDP)</td>
<td>below 3 percent</td>
<td>2.5</td>
<td>5.2</td>
</tr>
<tr>
<td>Government debt (percent of GDP)</td>
<td>below 60 percent</td>
<td>13.0</td>
<td>33.3</td>
</tr>
<tr>
<td>Exchange rate vs euro (2-year maximum percentage change)</td>
<td>+/- 15 percent</td>
<td>+10.8/-9.6</td>
<td>+3.9/-3.3</td>
</tr>
<tr>
<td>Long term interest rate (percent per annum, annual average)</td>
<td>&lt;2 pp above the average of the 3 best-performing EU Member States in terms of price stability</td>
<td>7.1 (criterion 6.4)</td>
<td>7.3 (criterion 5.8)</td>
</tr>
</tbody>
</table>

3Government of Romania estimate
4Own calculations based on IMF Staff estimates; reference countries are Greece, Belgium and Italy


3.1 Price stability

Looking at the evolution of inflation rate between 2007 and 2012 (figure 1), we can notice two periods of relative high inflation and increased spread between local interest rate and the one in 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 labor cost growth to very high levels. In 2009 inflation fell and broadly stabilized thereafter at around 6%, as the economic activity sharply contracted. Still, the gap with euro area remained significant. In 2010 inflation rate rose again, due to high increase in the price of international commodity, as well as 5 percentage point pick-up in the standard VAT tax starting with 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 favorable influence coming from the fading-out effect of VAT increase as well as easing pressures from energy and food prices owing to global prices and a very good harvest.

The latest available forecasts from IMF project inflation to increase in 2012-13 from historically low levels of 3% on average in 2012 to 3.2% in 2013, and then again to 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 criteria. However, there are upside risks, relating mainly to the dynamics of commodity and administered prices, the latter in the more medium term. Looking further ahead, the catching-up process is likely to have an important influence on inflation over the coming years, given that GDP per capita and price levels are still significantly lower in Romania than in the euro area. However, it is difficult to assess the exact magnitude of the effect resulting from this catching-up process.

**Figure 1 – Inflation rate (HICP)**

![Figure 1 – Inflation rate (HICP)](image)

Source: Eurostat, IMF estimates

### 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. Government deficit, as well as government debt, was comfortably below the reference values, which was considered a big advantage, as these issues require the most painful adjustments.
Starting with 2008, the share of Romania’s general government deficit in GDP exceeded the limit 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 government deficit to 5.2 percent of GDP by end-2011. ((National bank of Romania, Annual Report 2011)

As decided in the EU-IMF financial assistance programme, Romania is on track to reduce 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.

**Figure 2 – General government deficit (% of GDP)**

![Graph showing general government deficit (% of GDP) from 2002 to 2015 for the Euro area and Romania.](image)

Source: Eurostat, IMF estimates, Government of Romania Convergence Programme 2012-2015 estimates

### 3.2.2. Government debt

The second indicator of public finance sustainability, the government debt, is one criterion which had been below the reference value since Romania entered the European Union. The current financial crisis had a negative impact on government debt, which rose from 13% in 2007 to 23% in 2009 and continued to rise to over 30% in 2010-2012. With all this, it continued to post a level by far lower than the limit 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. Projections provided by Romanian authorities and
by IMF show only a slightly decline in government debt, to 31.8%, respectively 32.9% by 2015.

**Figure 3 – General government debt (% of GDP)**

The long-term interest rate had 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%. From 2008 though, the upward trend of local interest rates sharply intensified against the backdrop of a deterioration in economic activity as well as owing to an increase in monetary policy interest rate. Tensions in international financial markets led to a high volatility of long term interest rate, which reached its peak in July 2009 at 11.46%. Since then, long-term interest rates were subsequently placed on a downward trend, supported by easing inflationary pressures and a decline 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 recent financial turmoil, in parallel 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 further 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.

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

**Figure 4 – Long term interest rates in Romania (percent per annum, annual average)**

![Interest Rates Graph](image)

Source: ECB Statistical Data Warehouse

**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 foreign investors’ perception on the risks associated with Central and Eastern European economies. After Romanian Government signed the agreements with the international financial institutions in 2009 and the financial tensions in the region alleviated, evolution of the leu exchange rate versus the euro became relatively stable. Between December 2010 and December 2012, 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 (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 4.5 lei/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.
4. Conclusions and future prospects

The current financial crisis had a major 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, major 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 fulfill all 5 criteria by 2015. Analyzing the data, I sustain that the actual target for euro adoption could be respected, provided further progresses are made regarding inflation rate reduction. I also consider that the target should be respected, as it would represent a strong stimulus for the local government to implement further measures to alleviate public indebtedness and to reduce inflationary pressure.
References

- ECB Convergence Report, 2011
- Government of Romania Convergence Programme 2012-2015
- IMF, Annual Report 2012 – Working together to support global recovery, Appendix I
- Isărescu, M. (2007), Romania, drumul către euro (Romania, the road to euro), Paper presented in the Conference organized by Academic College of „Babeș-Bolyai”, Cluj Napoca, 2004 (updated version March 2007)
- National bank of Romania, Annual Report 2007
- National bank of Romania, Annual Report 2011

*** www.worldbank.org
***www.eurostat.ec
***www.imf.org
***www.ecb.int
***www.bnr.ro