Perspectives on Fulfilling the Nominal and Real Convergence Criteria by Romania for the Adoption of Euro Currency

Geza, Paula and Giurca Vasilescu, Laura

1 April 2011

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Paula Geza
Laura Giurca Vasilescu

Abstract:

In the present, Romania is considered a fragile state. While the lowest point of recession seems to have been exceed, the instability continues to characterize for a period all efforts and steps taken for economic recovery. Regarding the real convergence criteria, on December 2010 Romania presently continues to meet only the criterion regarding the sustainability of fiscal position while the assessment of the criterion related to the stability of the exchange rate cannot be performed accurately as long as the national currency – Leu - does not participate to the Exchange Rate Mechanism II (ERM II).

Key words: Real convergence criteria, Nominal convergence criteria, Euro adoption, Romania

JEL Classification: E42, F36

The adoption by Romania of the Euro currency at the proposed date (2014) through the Convergence Programme that our country submitted to the European Commission at the beginning of 2007 depends on the concurrent accomplishment of the nominal and real convergence criteria. The nominal convergence criteria which must be met by the countries joining the Economic and Monetary Union were laid down in the European Union Treaty known as Maastricht Treaty and include the following criteria: price stabilization criteria, fiscal stabilization criterion, criterion of long-term interest rates and stabilization of the national currency exchange rate within the framework of the European Rate Mechanism II (ERM-II).

The first criterion specifies the maximum inflation rate which cannot exceed the average inflation rate of three EU members countries with the lowest inflation, by more than 1.5 percentage points.

The criterion of fiscal policy specifies that the top value of the budget deficit to GDP ratio cannot be higher than 3% and the public debt cannot exceed 60% of GDP.

The criterion of long-term interest rates specifies that the level of long-term interest rates cannot exceed by more than 2 percentage points the average percentage interest rate in 3 EU countries of the lowest inflation.

Last but not least the country which is candidate for the Economic and Monetary Union must introduce its currency to the ERM II. This means an agreement with the National Central Bank which put the candidate country under the obligation to ensure full convertibility of the currency, making the central currency rate rigid in relation with the Euro and its stabilization within the fluctuation margin+/- in the period of at least 2 years without implementing devaluation.

Among the nominal convergence criteria Romania presently continues to meet the criterion regarding the sustainability of fiscal position, while the assessment of the criterion related to the stability of the exchange rate cannot be performed accurately as long as the Leu does not participate to the Exchange Rate Mechanism II (ERM II).

From the point of view of fulfilling the real convergence criteria and according to data published in December 2010, the situation would present as follows:

- The Inflation Criterion - the inflation rate of a state which adheres to the Euro currency should not exceed by more than 1.5 percentage points the average of the lowest 3 inflation rates recorded in the European Union. At the end of November the lowest 3 inflation rates recorded in the EU were attributed to Ireland (-0.8%), Slovakia (1%) and the Netherlands (1.4%) –

their average reaching 0.53%. Within the same period the inflation rate in Romania reached 7.7% (the highest recorded in the European Union), that is almost 4 times higher than the criterion states and 14.5 times higher than the average of the three lowest inflation rates recorded in the European Union. The annual inflation recorded in 2010, of 7.96%, went far beyond the target inflation range established by the National Bank of Romania – namely 3.5% +/- 1 percentage point.

- The Budgetary Deficit Criterion - the condition for a certain state to adhere to the Euro zone imposes that the budgetary deficit should not exceed 3% of GDP. In 2008, the Romanian budgetary deficit doubled. In 2009, it augmented from 5.4% of GDP to 8.6% of the GDP. In 2010, the budgetary deficit of Romania amounted to 33.3 billion Lei, and respectively 6.5% of GDP, which is under the limit of the target of 6.8% of GDP agreed with IMF.
- The government debt to GDP ratio - should not exceed 60% of GDP, or, in the event this level is exceeded, a country should prove its stable tendency of deceleration of the government debt to GDP ratio. Although Romania still meets this criterion, its dynamics is absolutely alarming. From less than 22% government debt ratio recorded in 2008, in 2009 it increased to 147.33 billion lei, respectively 305 of GDP; in 2010 the level of government debt reached almost 8% (46.6 billion lei), pursuant to a decrease of the budgetary deficit of almost 1% of GDP. This means that the government debt was forced down by the loans to be paid at due date in 2010, many of them being extended in 2011.
- The Exchange Rate – The national currency should fluctuate for two years as compared to a reference level of +/- 15%. Although Romania does not participate yet to the ERM II, we could state that this criterion could be met due to sufficient currency reserves and a good coordination on behalf of NBR.
- The Long Term Interest Rate **–** The long-term nominal interest rate should exceed by 2 percentage points, at the most, the interest rate recorded in the countries with the lowest inflation. In 2009, the interest rate in all 3 states was 6%; yet, it amounted to 9.4% in Romania.

In 2011 an economic recovery is expected as the real GDP is foreseen to increase by 1.5%. Subsequent to its serious decrease in 2009 and 2010, the investments should dynamically recover by 4.2% and they are expected to turn into a main growth factor as the societies readapt their production lines in order to meet the increasing external demand. Exports remained high during 2010 and together with a certain bounce of industrial orders their evolution is expected to recover the companies, even though the broad reach of risk factors remain somewhat increased. Moreover, the augmentation of the absorption degree of EU substantial funds would provide an impulse for investments in the infrastructure. Subsequent to a considerable reduction in 2009 (-10.6%) and 2010 (estimated by 1.6%), the domestic consumption shall recover slightly in 2011 by 1.8%, as the salaries shall reach a regulatory ascending trend. This tendency shall be nevertheless inhibited by the continuous fiscal reduction and by the high percentage of debts into services-revenues which shall also lead to large unrealistic bad loans (almost 12% in September).

After having faced a positive global impact in 2009 and 2010, net exports are expected to make a negative contribution to the economic development next year as the imported capital goods increase thus feeding the augmentation of investments. As Romanians living abroad benefit from the improvement of conditions existing on the foreign labour market, the remissions of workers should increase again by 2011. The current account deficit is estimated to freeze at 5.6% of GDP.

The fiscal situation deteriorated in the first months of 2010, mainly due to the reduced performance within the field of revenues. The deficit target established by the Government of Romania for 2010 was revised towards an ascending trend to 7.3% of GDP.

In order to reach the revised target, Romanian authorities took additional strengthening measures, including a temporary reduction by 25% of salaries within the public sector, a reduction by 15% of social expenditure, except pensions and an increase in VAT rate from 19% to 24%. Moreover, the authorities decides to reduce by 10% the expenditure incurred for goods and services and the anticipated retirements have been frozen since the 1st of June 2010 until after the reform of the pensions' system, expected to enter into force. The social contributions and the individual assessment basis based on revenues have been increased and the authorities also committed to reduce more the number of personnel towards the end of the year; these jobs cuts exceeded 25,000 jobs in the first half of 2010.

The fiscal consolidation measures adopted guided Romanian towards an ascending trend in order to reach the deficit target of 7.3% of GDP in 2010. Nevertheless, Romania continues to be affected by recurrent arrears, especially in the field of health.

The deficit for 2011 is foreseen to continue to decrease to 4.9% of GDP, taking into account the carrying forward of fiscal consolidation measures for 2010 and additional savings within the item of expenditure established by the authorities. These include a reduction of subsidies for electricity, a freezing of pensions in nominal terms, a further reduction of employment in the public sector; the policy on replacing only 1 of 7 employees deciding to leave the company, the implementation of future reforms in the health system and an improvement of audit measures on income and expenditure shall continue to be applied. The budgetary deficit is estimated to decrease at 3.5% of GDP in 2012, on the supposition that policy shall remain the same.

While the prognosis of the European Commission supposes that authorities shall not amend the fiscal consolidation measures taken in July 2010, there are substantial risks which may jeopardize the consolidation strategy. Currently Romania faces a high pressure put on authorities in order to go behind these measures implemented in July 2010 and to recommence the non-sustainable expenditure policies. While this procedure may provide some short-term incentives as regards the internal demand, on medium and long term it may lead to the severe reduction of the economic growth potential.

As a conclusion – currently Romania is a fragile state. From an economic point of view it is seriously affected by the global financial crisis and its impact appears to be lasting nowadays. According to "Business Monitor International (2010)", while the lowest point of recession seems to have been exceed, the instability continues to characterize for a period all efforts and steps taken for economic recovery.

In terms of the economic situation, Romanian economy currently faces some important weaknesses:

- The increase of dependence on external funding correlated to the lack of development of national capital and production structures;
- An unprecedentedly increased of mortgage loans;
- A small number of foreign companies hold the dominant position on the market while Romanian companies face an acute absence of competitiveness;
- The risk of currency fluctuations not necessarily determined by the inflows of foreign capital;
- A procyclical fiscal policy corroborated with excessive governmental expenditure;
- The existence of a crisis affecting the public money management determined by the poor governing and by the absence of a strategy regarding the design of a complex policy.

The actual financial crisis introduced a steep reversal of the appreciation trend of the Romanian leu with important episodes of volatility. As in the past the currency inputs overrated the Romanian leu far beyond the level indicated by the fundamental factors of the exchange rate, nowadays the reduction of external financing and uncertainty tend to determine the undervaluation of the Romanian leu not justified by the fundamental factors of the exchange rate. The reserves bought on the currency market during the overestimation periods presently serve for interventions aimed at relaxing the depreciation of the Romanian leu. During this period of turbulences and uncertainties Mr. Mugur Isărescu recommends the program for adopting the Euro currency. Romania should comply with its previously notified schedule for the adoption of the Euro currency specifying that the embracing of the exchange rate mechanism ERM-II beginning with the 1st of January 2012 and the transition of the mandatory minimum period of two years is conditioned by the need to put into place several reforms, both appropriate and competent, until 2012.

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