



Munich Personal RePEc Archive

Convergence to EMU through the Test of the Public Finance –Romania’s Budgetary Deficit and Public Debt

Susanu, Monica

Dunarea de Jos University Galati, Romania

4 April 2009

Online at <https://mpra.ub.uni-muenchen.de/20480/>

MPRA Paper No. 20480, posted 09 Feb 2010 09:11 UTC

Monica Susanu

"Dunarea de Jos" University of Galati, Faculty of Economics, Galati, Romania

CONVERGENCE TO EMU THROUGH THE TEST OF THE PUBLIC FINANCE – ROMANIA'S BUDGETARY DEFICIT AND PUBLIC DEBT

ABSTRACT

The convergence criteria group together those macro variables whose dimensions mean to put in good use, to potentiate and to strengthen the major benefits of integration, as their configuration, either before and especially after the adhesion in EU, represents strict and compulsory requirements for each state. The very reason stands in the strategic target of adopting euro currency, as an advanced phase of the integration which thus brings together the negative integration – meaning the abolition of the various obstacles in common market functioning -, with the positive integration – that means that minimum action of the public authority mainly aimed to ensure the coordination and harmonization of the economic policies.

Either budgetary deficit and public debt contain the quintessence of the convergence efforts in taking into account the public finance, since both indicators exhaustively mirror the government's administration and interventionism, and reflect its practices and macroeconomic policies strategies. At the same time, they contain information and facilitate estimation and prognosis concerning not only that country's estate and future, but the Union's stability and future as well, since it represents an integrated system of many countries, a unitary whole of common goals and interests.

The globalisation is the outstanding economy's characteristic either in present and future tense, which is a fact obviously confirmed by the propagated negative effects of the recent financial crises. The increasing importance of evaluating each country's budgetary deficit and public debt, as much as each country is a part of a whole, is henceforth a reliable link for the member states of this great system. The globalisation also favours the access and the extension of a multitude and various risks, which are able to penetrate through any split of any size. These public finance indicators are instruments enabled to operate as a primary and decisive court meant to signal and to preview the threatens against the system's structure and stability, to prevent and remove these dangers, and also to heal long-term and bad effects.

Key words: *budgetary deficit, public debt, the convergence criteria*

JEL classification: *G18, H62, H63, H68*

1. INTRODUCTION

The creation and acceptance of the euro area in 1999, a key landmark in the history of European integration, were proofs of highest confidence in Europe as a whole and challenges in the context of the global economy. As unique currency, euro caused a host of transformations all over the euro-area that were planned to increase the competition in a global economy, to sustain and to spread the well-known economic stability of the core countries.

Actually, euro means the fulfilment of the common market, the very warrant of the four liberties; although a political and institutional profound reform was necessary. By the anniversary of its first decade, euro area witnessed the macroeconomic stability, an essential prerequisite for a sound and lasting economic growth as characterised in the recent past years.

The creation and the simultaneous acceptance of the euro currency by many different countries were preceded by a process of nominal convergence that determined important effects on the economies of participating countries; it also led to convergence of public finances, associated with notable differences in the behaviour of key macroeconomic aggregates. Compared to the *core countries*, some of the *converging countries* experienced a boom in domestic demand and a severe deterioration of their current account and budgetary deficits.

Key macroeconomic variables in each of the converging countries were affected by a host of specific shocks, including common shocks emanating from the global environment (e.g. changes in world demand, world interests rates and oil prices) and country specific shocks as well.

According to the 121st article of the Treaty, the sustainable character of the public finances results from a budgetary situation that does not know an excessive public deficit by the meaning and definition of the 104th article, 6th line. In its turn, this article states that the European Commission makes a report about the member state that does not cope with the requirements of the fiscal discipline, especially when:

- a) The planned or effective *deficit rate to GDP* exceeds 3% as reference value, except for:
 - Significant and firm diminution up to the reference value, or
 - It is only an exceptional and temporary exceeding and the respective rate is sustainably close to the reference rate;
- b) *Public debt rate to GDP* exceeds 60% as reference value, unless this rate is sufficiently diminishing satisfactorily close to the reference value.

At the same time, EU Commission's Report has to take into account the investments expenditures and the economic and budgetary member state's medium-term position as well. In this report, the EU Commission is also enabled to warn that there is a risk of an excessive deficit despite the fulfilment of the convergence criteria.

With a view to analyzing the convergence, the ECB has to express its opinions regarding the fiscal development, following the evolution of the main variables during

1998-2007 periods, to estimate the perspectives and challenges concerning the public finance and then it focuses on the connexions between deficit and debt trends.

The ECB's analysis is grounded upon the data that are extracted from the national accounts and in accordance with the European System of Accounts (ESA) 95. According to the Maastricht Treaty, the EU Member States also become EMU Member States with temporary derogation as about the acceptance of the common currency. Firm and rigorous economic policy measures are necessary to be implemented with a view to achieving the nominal convergence criteria and to further accomplish the real convergence processes.

Table 1: Key European and ECOFIN Council statements on the role of quality of public finances, 2000-2007

Date	Statements/ Key issues
Lisbon, March 2000	The European Council called for using the "opportunity provided by growth (...) to pursue fiscal consolidation more actively and to improve the quality and sustainability of public finances" and requested the Council and the Commission to present a report by Spring 2001 on the contributions of public finance to growth and employment.
Santa Maria de Feira, June 2000	The European Council encouraged Member States to "review the quality and performance of public administration with a view to the definition of a European system of benchmarking and best practices."
Barcelona, March 2002	The European Council endorsed a Key Issues Paper, which defined quality of public finances as "achieving the appropriate structure of government revenues and expenditures to ensure sound and sustainable public finances while raising the potential growth of Union economies. In this light, tax and spending reforms must aim at creating the conditions to foster employment and investment, while adhering to the medium-term objective of a budgetary position close-to-balance or in surplus."
Brussels July 2005,	The European Council endorsed amendments to two regulations (1466/97 and 1467/97) that underpin the Stability and Growth Pact and which, among other revisions, take better account of the quality of public finances (QPF).
Brussels, March 2006	The European Council underlined "the need to further improve the efficiency and effectiveness of public spending and taxes in order to enhance the quality of public finances and foster growth and employment enhancing activities, in line with the priorities of the partnership for growth and employment."
ECOFIN Council, Luxembourg, October 2006	The ECOFIN Council stressed that the revised SGP underlines the important role that national fiscal rules and institutions can play in attaining sound budgetary positions and respecting the provisions of the Treaty and that national institutions could play a more prominent role in budgetary surveillance. Coupled with appropriate structural reforms, national fiscal rules and institutions can also contribute to improving the efficiency of public expenditure.

Brussels, March 2007	The European Council reiterated the need to further consolidate public budgets and safeguard the long-term sustainability of public finances. Moreover, it stated that "the quality of public finances needs to be improved by raising efficiency and effectiveness of spending, by restructuring public expenditure in support of measures that promote productivity and innovation and by strengthening human capital with a view to raising the long-term growth potential of the economy."
ECOFIN Council, Luxembourg, October 2007	The ECOFIN Council confirmed the importance of national fiscal rules and institutions. Also, it"(...) underlined that the modernization of public administrations can play an important role in enhancing competitiveness, delivering better services achieving better value for money and ensuring the control of government expenditure." (...) It invited the Commission to step up their efforts to improve the analysis, methodology and the measurement of the QPF, including the efficiency and effectiveness of public expenditures and revenue structures, as well as of major public sector reforms

Sources: http://europa.eu/european_council/conclusions/index_en.htm); European Commission - "Public Finances in EMU" – Oct. 2008, p.130

2. NECESSARY POLITICAL AND TECHNICAL DETAILS

The real convergence processes are equivalent to the diminution prices and productivity cross-border countries gaps, meaning the incomes increases in the developing countries up to the level from the industrialized developed countries ones. Although the real convergence criteria are not explicitly mentioned in the Maastricht Treaty, these complex processes are revealed by the level of GDP per capita under the Purchasing Power standards (PPS).

The fiscal convergence criteria urged the EU countries to consolidate public finances from the early – 1990's onwards in the run-up to the EMU on January 1999, when many EU legacy currencies were replaced by the euro. More recently, the adoption of the EU fiscal framework by the New Member States, when they joined the EU, has triggered changes in fiscal behaviour, as they are seeking to pursue sound fiscal policies within the framework of the Stability and Growth Pact

The convergence plan is firstly assessing the sustainable development opportunities under conditions of implementing the convergence itself, also taking into account the utmost importance of the advantages offered by the accession to the EU. *Nominal convergence* pace and timing should be established as to avoid delays and distortions in the *real convergence* actions. An excessively rapid pace of the nominal convergence could jeopardise its own sustainability, while its positive implications could be accompanied by short-run tensions among them.

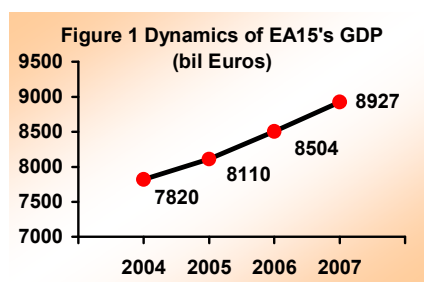
3. STATISTICALLY TALKING

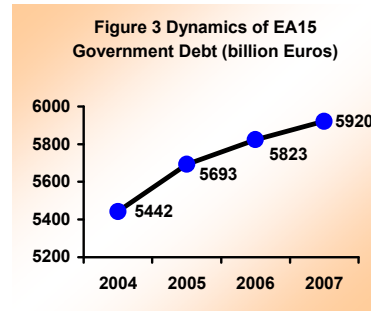
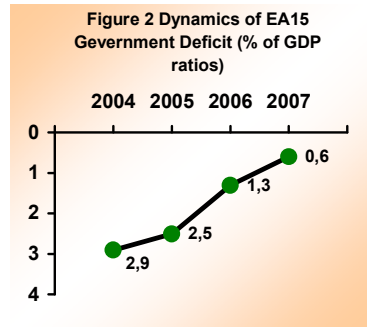
In 2007, the government deficit of both the euro area (EA 15) and the EU 27 fell compared with 2006, while the government debt increased in absolute terms. In the euro area the government deficit decreased from 1.3% of GDP in 2006 to 0.6% in 2007, and in the EU 27 it fell from 1.4% to 0.9%. In the euro area the government debt to GDP ratio fell from 68.5% at the end of 2006 to 66.3% at the end of 2007, and in the EU 27 from 61.3% to 58.7%.

Table 2: Dynamics in EU public finances reports

		2004	2005	2006	2007
<u>Euro area (EA15)</u>					
GDP market prices (mp)	(mil. Euros)	7 820 461	8 110 080	8 504 375	8 927 499
Government deficit (-) / surplus (+)	(mil. Euros)	-228 612	-203 031	-107 956	-55 538
	% of GDP	-2.9	-2.5	-1.3	-0.6
Government expenditure	% of GDP	47.6	47.4	46.7	46.1
Government revenue	% of GDP	44.6	44.8	45.4	45.5
Government debt	(mil. Euros)	5 442 080	5 692 630	5 822 676	5 920 457
	% of GDP	69.6	70.2	68.5	66.3
<u>EU27</u>					
GDP mp	(mil. Euros)	10 602 759	11 062 422	11 672 988	12 342 115
Government deficit (-) / surplus (+)	(mil. euro)	-303 952	-270 312	-165 793	-106 029
	% of GDP	-2.9	-2.4	-1.4	-0.9
Government expenditure	% of GDP	46.9	46.9	46.3	45.8
Government revenue	% of GDP	44.0	44.4	44.9	45.0
Government debt	(mil. Euros)	6 590 308	6 931 301	7 158 749	7 249 553
	% of GDP	62.2	62.7	61.3	58.7

Source: <http://ec.europa.eu/eurostat>





Source: <http://ec.europa.eu/eurostat> - author's calculations

The largest government deficits in percentage of GDP were recorded in 2007 by Hungary (-5.0%), Greece (-3.5%), France (2.7%) and Romania (2.6%). Among the Member States that registered a government surplus in 2007 are the following: Slovenia (+0.5%), Bulgaria and Latvia (+0.1%). In all, 16 Member states recorded an improved government balance relative to GDP in 2007 compared with 2006, while 11 a worsening.

Government expenditures in the euro area were equivalent to 46.1% of GDP, while in the EU 27 were 45.8%. As for the *government revenues*, documents indicate a ratio of almost 45.5% both in euro area and in EU 27. Between 2006 and 2007 there was a similar trend in both zones: the government expenditures ratio decreased, while the government revenue ratio increased slightly.

In the last two decades of the twentieth century the slow pace of economic growth and the costs of economic integration have put strong pressure on European government budgets. During these period governments have completed large cuts in public investment spending and have postponed tax reforms.

Due to the recent evolution in economic growth and the improvements of fiscal balance asked by the EMU construction, the European countries should undertake deficit financed of many structural reforms. Resorting to borrowing to finance structural policies is indeed justified even in a growth context, as long as it shifts burden of spending payments to the time where the policies imply benefits.

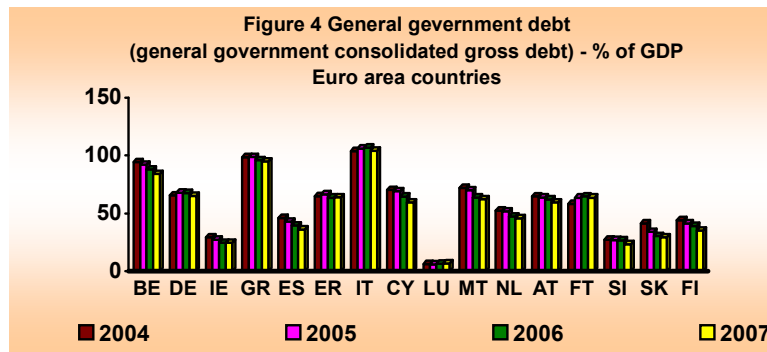
**Table 3: General government debt
(general government consolidated gross debt) % of GDP**

	2000	2001	2002	2003	2004	2005	2006	2007
Euro area	68.7	68.3	68.1	69.3	69.7	70.3	68.6	66.6
Bulgaria	74.3	67.3	53.6	45.9	37.9	29.2	22.7	18.2
Czech Republic	18.5	25.1	28.5	30.1	30,4-	29.7	29.4	28.7
Hungary	54.3	52.1	55.7	58.0	59.4	61.6	65.6	66.0
Poland	36.8	37.6	42.2	47.1	45.7	47.1	47.6	45.2
Romania	24.7	26.0	25.0	21.5	18.8	15.8	12.4	13.0
Slovenia		27.2	28.4	27.9	27.6	27.5	27.2	24.1
Slovakia	50.4	49.0	43.4	42.4	41.4	34.2	30.4	29.4

Source: EUROSTAT, "The European Union and the Commonwealth of Independent States" - Statistical comparison, 2008 edition; ECB, Monthly Bulletin, February, 2009

At the end of 2007, the lowest ratios of government debt to GDP were recorded in Estonia (3.5%), Luxembourg (7%), Latvia (9.5) % and Romania (12.9%), while eight Member States, among which was Hungary, had government debt ratios higher than 60.0% of GDP.

Specific literature about the consequences of new member states' EMU entry reveals that an initial increase of consumption causes afterwards an increase of both domestic and external deficit. They consider the driver of adjustment is convergence in interest rates between *core* (home) and *converging* (new member) countries. The explanation is that firstly, new members experience a sharp increase in household expenditures, accompanied by a current account deficit and the accumulation of a net debtor position with respect to the core (home) countries – and secondly, the initial sharp adjustment is followed by a process of slow adjustment reflecting the evolution of foreign liabilities/assets. After an initial jump, it declines gradually over time, reflecting the gradual increase of home's share in overall wealth.



Source: ECB, Monthly Bulletin, February, 2009, ECB for euro area aggregated data; European Commission for data relating to countries debt

4. RECENT (NON) ECONOMIC HISTORY

Since 2004 and then 2007 respectively, a comprehensive wave of ex-socialist countries joined the European Union select club, after a certain period of attentively preparing, difficultly facing unpredictable challenges and severe targets concerning their social, political and macroeconomic development.

The status of *convergent countries* for this platoon of new EU members was rather difficult to acquire and, as in the case of any analysis, the present one also has to take into account the decades of hyper centralized economy and society that these countries crossed with plenty of sacrifices and tragedies.

The space of the ex-Soviet Union is the starting place of the programme of stimulation of competition and initiative by removing (or, for starters, diluting) the state monopoly over property. Mechanisms to favour market economy were gradually introduced, being considered a sign on maturity, because only in this manner both competition and free initiative might have an open way. Along with the deepening of the problems related to international alignment and the political consequences resulted from the dismemberment of the ex-USSR, the institutional and functional reforms not only slowed down but an attitude of rejection of the population regarding private property and initiative became general; after the egalitarian tradition had ossified, the crises of the transitional process often took the shape of an explicit hostility towards differently distributed well-being. This is how serious phenomena of corruption and violence appeared and intensified, their amplitude being typical for all countries and representing a serious brake in the evolution of reforms.

A fierce confrontation of ideas and vivid theoretical polemics were recorded in connection to the ample transitional process started after the collapse of the totalitarian regimes according to the domino principle last millennium. As common ground, they had the same approach: treating transition outside standard models referring to competition and allotting of resources and well-being.

On a theoretical level, numberless programs and models were formulated and brought under discussion with a more or less declared appearance of miracle, of certain and indubitable universal panaceas but, unfortunately, these plans and formulas could hardly prove their viability, and if this happened, entirely exceptionally, it was only partially and only for a certain period and form.

However, in spite of the numerous controversies that still linger among politicians and scientists alike, there is a plus of coherence in the pragmatic conceptions that visualize this process *through IMF's glasses*, that is according to the amplitude and degree of propagation of the main internal and external unbalances, to the extent of market use, as well as to the degree of decentralizing the macroeconomic management.

The transitional process meant the reformation of the entire system; however, this complicated and dramatic process implies many and profound uncertainties, huge costs that are difficult to anticipate. This is why, at the end of approximately two decades of transition, this period is evaluated with different eyes; it is long and with poor or even

doubtful results which, here and there, determined not only the blocking of reforms, but also the regeneration of opposition towards change, consolidated the old rigidities instead of a long expected and just restructuring of the institutions and values.

The prerequisites of the differentiations regarding the unbalances can be the basis on which reformatory measures can be ordered, their duration and sequence of implementation in order to build the market economy can be assessed. From this angle, according to some specialists, certain criteria of making a hierarchy of those countries that have experimented transition can be detected as well.

For instance, the **Czech Republic, Slovakia, Hungary and Poland** are considered to have benefited from much more attractive and favourable circumstances to rapidly and efficiently apply and assess certain pertinent structural reforms, unlike **Romania and Bulgaria**, where such measures are still delayed or applied in a distortional manner.

The explanation resides in the superior degree of certain essential balances that are functioning in the case of the former, whilst the latter experienced a higher level centralization of government's decision and intervention. Keeping this background in mind, the relatively superior flexibility of the countries belonging to the first category ensured them an increased acceleration in their passing towards a democratic society, since they had passed the phases of creating and consolidating the essential elements of this purpose, namely: general consensus of social and political order, stabilization and macroeconomic control, prices, market and companies reform, privatization and a more clearly outlined perception of the role of the state.

The *defining* characteristics of these countries' evolution have included:

- a) *the upward dynamics of production and GDP*, as a result of the positive evolution of the indices referring to growth which show that the main sustaining factor was the expansion of exports towards western countries, especially after the dilution of the recession the latter countries crossed at the beginning of the 10th decade, but also as an expression of the perspective political and economic orientations of these countries;
- b) *the control and reduction of the annual rates of inflation*, by adopting certain restrictive budgetary and monetary policies which, though did not end up into an acceptable reduction of unemployment and inflation, ensured these indices premises of control and reduction in time; it is worth mentioning the effort to stay within the limits of budgetary deficits, as it had been agreed with or recommended by IMF officials;
- c) *the improvement of the commercial balance and of the current accounts* determined *the reduction of the external unbalances*, both on account of the depreciation of the national currency, as well as by reducing the unitary production costs, as a sign of advancing along the line of restructuring the real sector; besides the increase of exports, another favouring elements in terms of the external balance was the relative reduction of imports, also caused by the commercial measures of protectionist nature.

In spite of the fact that a series of inherent differences among countries and periods is still logically present, one may resort to a global assessment of the results of the first decade of re-conversion to capitalism.

Table 4: Government deficit/surplus & public debt (% of GDP)

		2004	2005	2006	2007
Bulgaria	Deficit/surplus	1.6	1.9	3.0	0.1
	Debt	37.9	29.2	22.7	18.2
Czech Republic	Deficit/surplus	-3.0	-3.6	-2.7	-1.0
	Debt	30.4	29.8	29.6	28.9
Hungary	Deficit/surplus	-6.4	-7.8	-9.3	-5.0
	Debt	59.4	61.7	65.6	65.8
Poland	Deficit/surplus	-5.7	-4.3	-3.8	-2.0
	Debt	45.7	47.1	47.7	44.9
Romania	Deficit/surplus	-1.2	-1.2	-4.2	-2.6
	Debt	18.8	15.8	12.4	12.9
Slovenia**	Deficit/surplus	-2.2	-1.4	-1.2	0.5
	Debt	27.2	27.0	26.7	23.4
Slovakia	Deficit/surplus	-2.3	-2.8	-3.5	-1.9
	Debt	41.4	34.2	30.4	29.4

Note: *Estimated data

** Recently EMU member state

Source: <http://ec.europa.eu/eurostat> - author's calculation

Poland has witnessed the most abrupt transformations under the guidance of the well-known clandestine union movement *Solidarity*, which, becoming the governing political party after 1989, took over and administered a disastrous “inheritance”. The social-democratic impulse of perpetuating the subsidies of prices for social protection purposes overlapped with the inherent restraints of a competition-based economy and with an overwhelming external debt (approximately 40 billions USD). The prices were liberalized and the salaries rigorously controlled so that, together with incentives for foreign capital investments, privatization and devaluation, the way to social and economic behaviours was wide open towards development and competition. The program entitled “*shock therapy*” pulverized the social consensus accumulated before 1990, demonstrating the failure of undecided and hesitating measures but determining, nevertheless, at the same time, the fall into a multifaceted crisis, also accentuated by the loss of faith in the infallibility of certain landmarks.

Hungary stepped with equal determination towards market economy ever since the ‘70s, when the private commercial banks were legalized in a practically generalized context of economy privatization. It is considered that this was ingredient that ensured the social stability of the reforming measures in spite of the fact that austerity measures regarding the freezing of salaries have been taken during the latest years and that the external debt of the country is more than significant. The rhythm of reforms does not require a high speed anymore already and the surmounting of the difficulties has new,

palpable achievement perspectives based on foreign assistance drawn by the plus of credibility.

A different case in point is the ex-**Czechoslovakia**, which had the highest GDP of all eastern-central European countries as well as a slender external debt; despite all the advantages of the general consensus and of the relative prosperity, the government's requests that the population should consent to a number of sacrifices generated disturbances of the balance which ended up in the consensual and peaceful scission of the country into two distinctive state entities: The *Czech Republic* and *Slovakia*.

Bulgaria began the reforms in February 1990, when the government program of state-owned companies' flexibility was in fact the expression of choosing a gradual transition. The liberalization of prices was only partial – for luxury products especially; the prices for basic food products and those considered strategic, such as oil and steel, continued to work in a centralized manner and by public subsidy, precisely not to imperil the precarious social stability and support.

Eastern Germany took a completely different trajectory, taking into account the position of maximum advantage conferred by its western “sister”; this fact also favoured its admittance into the European Union, practically by an “adoption”, not only unconditional but also protected against the tribulations and costs of the stern programs that the other transitional processes were forced to endure.

The figures below contain the dynamics of the macro variables in some ex-socialist countries that are reflecting the convergence process and the tendencies they follow:

Table 5: Public finances dynamics tending to EMU

<u>Country</u>	<u>year</u>	Public finances variables		
		Excessive deficit procedure	Public administration deficit	Gross Public debt
Bulgaria	2006	-	3.0	22.7
	2007	No	3.4	18.2
	2008	No	3.2	14.1
Czech Republic	2006	Yes	-2.7	29.4
	2007	Yes	-1.6	28.7
	2008	Yes	-1.4	28.1
Hungary	2006	Yes	-9.2	65.6
	2007	Yes	-5.5	66.0
	2008	Yes	-4.0	66.5
Poland	2006	Yes	-3.8	47.6
	2007	Yes	-2.0	45.2
	2008	Yes	-2.5	44.5
Romania	2006	-	-2.2	12.4
	2007	No	-2.5	13.0
	2008	No	-2.9	13.6
Slovakia	2006	Yes	-3.6	30.4
	2007	Yes	-2.2	29.4
	2008	Yes	-2.0	29.2

Source: ECB, Convergence Annual Report, May, 2008 – author’s calculations

Besides economic conditions, there are certain general characteristics of the post transitional economies, such as: fragmentation of decision-making, ideology of the party in government and especially the closeness of elections. These are impact elements for the efficiency of the fiscal policy in general and in the adjustment strategies in particular.

5. OVERALL ECONOMIC AND TECHNICAL FRAMEWORK

In the second half of 2008, signs of weaker economic activity started to emerge in the largest *central and eastern European EU countries*. For instance, third-quarter GDP data for Hungary show that the economy contracted by 0.1% quarter on quarter. In the Czech Republic and Poland, real GDP growth fell slightly in the third quarter, to 0.9% and 1.2% respectively. Short-term indicators point to a further reduction in growth in both countries. In Romania, real GDP growth remained strong in the third quarter (partly driven by a good harvest in the agricultural sector), but short-term indicators suggest a marked decline in more recent months.

The macroeconomic outlook has worsened substantially in the past few months in all four countries as a result of increased risk aversion towards the region, tighter financing conditions and contracting international trade. Annual inflation rates have

declined, falling in December to 6.4% in Romania, 3.4% in Hungary and 3.3% in the Czech Republic and Poland. EMU represents the 3rd stage of the economic and monetary union. The convergence criteria are designed to guarantee that prior to joining the EMU, countries attain a high of economic convergence both in real and in nominal convergence. These criteria affect the way fiscal and monetary policy should be conducted in the EMU accession countries. Since each of the Central Eastern European countries signed the Maastricht Treaty, it also includes their obligation to enter the EMU in the near future. As stated in the Treaty, these countries are required to satisfy certain restrictions on their debt and deficit policy.

Testing convergence by the budgetary deficit. There are four countries that are the object of an EU Council decision referring to an excessive deficit procedure. According to the data that are recorded in May 2008, Czech Republic, Poland, Hungary and Slovakia are in this procedure after the data of 2006. Ironically, it is worth to mention that, at a value of only 2.5 % of GDP deficit in 2007, Romania was far from the excessive deficit procedure and moreover, a deficit of only 2.9 % of GDP was predicted for 2008. Unfortunately, by the end of 2008, Romania's deficit was overtaking even the 5 % to GDP threshold, meaning a certain qualification for the excessive deficit procedure.

Testing convergence by public debt. According to the same document, these countries' public debt reveals lower values than the threshold of 60% to GDP ratio, except for Hungary, but with descending tendencies for the near future. The same trend is followed by Czech Republic, Poland, Lithuania, Latvia, Estonia, Slovakia and Bulgaria, mainly due to the diminishing the primary budgetary deficit.

As for Romania, the amount of the public debt was only 13 % to GDP in 2007, and the prognosis for 2008 showed a slight increase in the relative value, insignificant from the reference value.

There is a large literature on the impact of the monetary policy on economic activity, whilst fiscal policy has received less attention and its importance for economic stabilization has been typically neglected. The recent financial turmoil has, however, revived the interest of academia, central bankers and governments on the role of fiscal policy. When analysing the role of fiscal policy in the context of a monetary union, certain studies show that there is a stabilizing role for fiscal policy, that goes beyond the efficient provision of public goods, as monetary policy is conducted by common central bank, while fiscal policy is implemented at the country level.

As a stabilizer of macroeconomics, the fiscal policy should be approached according to the phase of the economic cycle, i.e. more lax within a recession and more restrictive within a boom. The identification of the fiscal structural stance allows the assignment of the fiscal policy as a macro stabilizer. Structural fiscal position is the prevailing part of the deficit while there is no influence from the economic cycle.

The structural fiscal position may be considered in dynamics from the perspective of the fiscal stance, as long as this reflects the modification of the *structural fiscal position* from one moment to another. As an alternative, the *fiscal impulse* could be also relevant, because it is equal to the fiscal stance, but with an opposite sign. For

instance, a positive fiscal impulse indicates a laxer fiscal policy that could imply inflationary effects, although the effective deficits indicate a decrease.

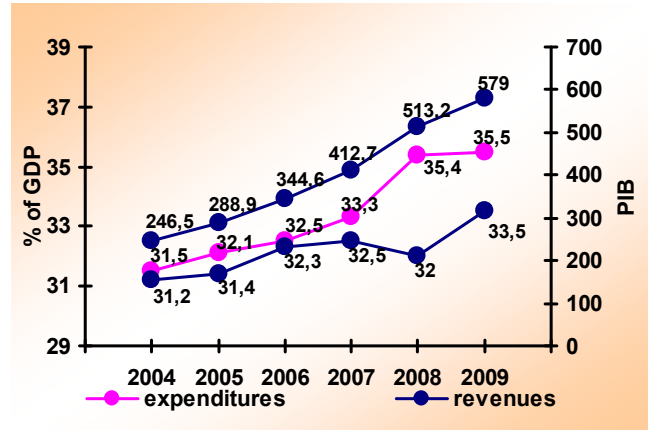
When the fiscal impulse is operating in the same time with an excessive demand, one can state that there is a pro cyclical fiscal policy, meaning not only a failure as a macro stabilizer, but even an inflation amplifier because of the excessive demand. It is worth to mention that ESA 95 Standard means an accrual system of registration based on agreements, not only on effective payments.

6. CONVERGENCE TO EMU THROUGH THE TEST OF PUBLIC FINANCE

In Romania, the relevant changes began to produce good results since 2000, when the stability and functioning of the economy were achieved on basis of new principles. Henceforth, convergence scenarios and calculation should be considered from 2000 on, as they gained significance and credibility for the future evolution of Romania's economy and it began a normal development. Romania's fiscal policy was a pro cyclical one based upon unrealistic estimations of the revenues and exaggerated growth of the expenditures that induced significant macroeconomic imbalances, especially for the current account and the high rate of inflation.

The tendency of contracting the economic activity has visibly further emphasised by the beginning of 2009, but a recovery of the domestic supply and demand is expected as EU' efforts of economic and financial setting rights are to be seen. Despite a possible decrease under the limit of 1% to GDP ratio, the macroeconomic framework predicts a growth with 2.5% as against 2008.

Figure 5 Government revenues and expenditures (% ratios to GDP)



Source: www.guv.ro

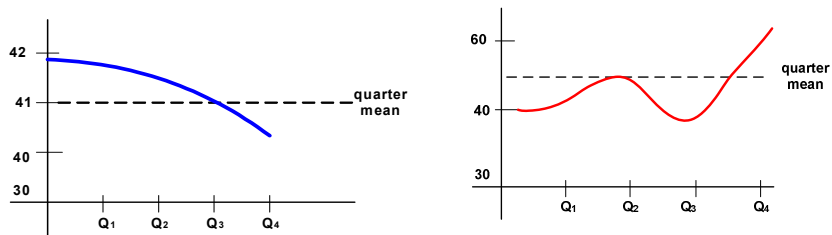
Although planned at a 37.2% to GDP ratio, the public revenues were but 32% to GDP ratio accomplished while the expansionary policy of the expenditures caused a deficit

of 4.8 % to GDP ratio – according to cash methodology, and 5.2% to GDP ratio following the ESA - 95 manner. One can evaluate this as a totally unacceptable situation after almost 8% growth ratio in 2008.

An additional reason to worry about is their inefficient orientation towards salaries and many different non-durable goods and services.

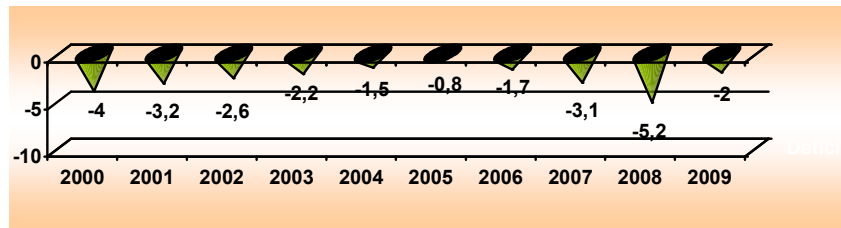
In the 4th quarter of 2008 the general government’s expenditures raised by 30 per cent compared to the previous period, while the budgetary revenues diminished by 2.6 per cent. It means that the corresponding quarterly budgetary deficit was about 16 billion ROL, as against only 2 billion ROL in the previous quarter.

Figure 6 Quarterly budgetary revenues/expenditures during 2008 (bill ROL)



Source: www.guv.ro

Figure 7 The Fiscal Deficit (% to GDP ratio)



Source: NBR, www.bnr.ro

There are some aspects that also confirm the negative impact of the deficit as reported by the end of 2008, such as:

- the amount of *the unobserved economy* that raised from 14.5 % to GDP in 2004, to 21 % to GDP in 2008, meaning a 3 times increase during the period 2005 – 2008;
- the *free labour* makes the important part of the unobserved economy, at about 51 % of the whole and 11 % of the GDP;
- the *fiscal avoidance* by VAT paying increased to 24 billion ROL, as against 7.4 bill ROL in 2004, and meaning 5% to GDP.

Fiscal policy effects upon 2009 trends can be analysed as follows:

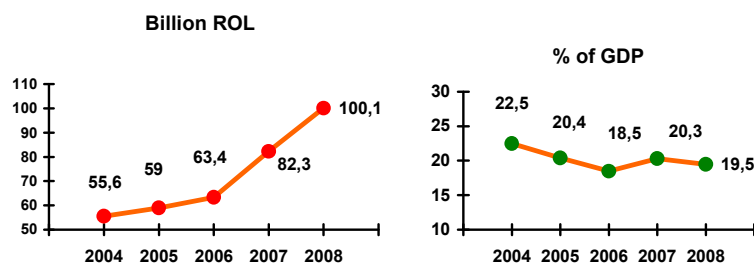
External effects. The overtaking of 3 per cent of GDP budgetary deficit as SGP stated ratio exposes Romania to the excessive deficit procedure; additionally, the international rating agencies severely penalised Romania with (BBB-) note, that is to trigger negative consequences concerning the financing of the government's foreign debt. Both deficit and fiscal unpredictability lead to a lack of the foreign investors' trust in the Romanian economy's perspectives. Thus, during the 4th quarter only the FDI flows decreased twice, from 943 million Euros in October, to 400 million Euros in December 2008.

Domestic effects: over 1.5 of GDP, meaning 2.1 bill Euros, were central and local public administration's unpaid claims to certain economic companies and that induced a sudden contraction of the economic activity, especially in building construction;

■ the government debt was 16.4 billion ROL by November 2008 more than 2007, because of financing an unexpected deficit, considering the international financial turmoil additionally. Thus, Romania has to face a very hostile and difficult economic environment, taking into account the necessity of shortening the public expenditures and deficit too. Moreover, the slow absorption of the EU structural funds made an important surface of land not to be used for agricultural purposes.

Government debt. The real increase of public debt by the end of November 2008 as compared to 2007 was due both to the necessity of deficit financing and to the valuation of the debt which was denominated I foreign currency. The depreciation of the national currency to EUR and USD also contributed in a great extent to increasing the foreign debt burden.

Figure 8 Dynamics in the government's debt

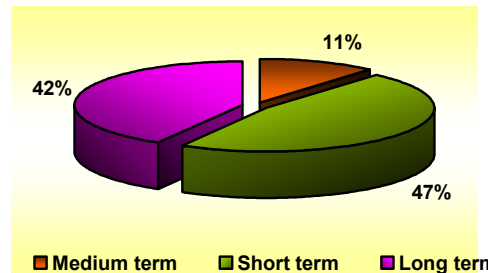


Source: www.guv.ro

The *debt* of 16.4 billion ROL more than 2007 was caused while financing the deficit and by the temporary financing from the general current account of the State Treasury. Credits contracted with domestic and foreign investors raised with an amount of 8.4 %, while the temporary financing from the State Treasury increased with 28.9 %, i.e. 8.5 billion ROL compared to 2007.

The structure of credit's initial duration reveals that 53 percent consist of medium and long term contracted loans (over 1 year), but 47 % is represented by short-term debt that would further increase the high risk in refining the government debt.

Figure 9: The structure of the Public Debt (% to GDP ratio)



Source: www.guv.ro

Considering the interest rate, 65.7 % of total debt is contracted under a floating interest rate, showing high interest rate risk accompanying the public debt.

7. ROMANIA'S PERSPECTIVES FOR THE ADOPTION OF EURO

For the post-accession period and with a view to adopting the Euro, main strategically objectives are to be followed by each accessing country:

- the consolidation of a low inflationary rate;
- the consolidation of the domestic long-term capital market and the convergence of interest rate;
- the relative sustainability of the exchange rate around the equilibrium long-term level.

One can appreciate that Romania's preparations for the EU accession took a right way beginning with 2000, when also targeting the inflation started, as this was the most serious threat for the converging process. Therefore, all necessary measures of monetary policy were constantly taken to fulfil this major objective. Additionally, the crisis risk that was already perceived by the Romanian economic reality of 1998-99 periods raised the issue of a monetary council.

Contrary to Bulgaria, with which joined EU in January 1, 2007, Romania chose an autonomous monetary policy taking into account the following pertinent explanations:

- quasi-deficit were larger than the fiscal ones and were not apt to be influenced by regime switch;
- an insufficient level of foreign exchange reserves;
- the fragile banking sector that was not restructured yet.

Therefore, at least until ERM 2 entry, inflation targeting is to be maintained as the strategy ensures a gradual fulfilment of the Maastricht criteria, while supporting the real convergence process. The moment of ERM 2 entry is planned by 2012, taking into account that 3-4 years after accession would be sufficient both to imply the nominal convergence and to significantly progress in the real convergence. The necessary stay

in ERM 2 is considered to be 2-3 years, but the NBR officials stated to shorten this period until to 2 years as minimum compulsory duration.

Euro adoption is thus expected for Romania in 2014.

Table 6 The Schedule of EMU Accession

Country	Date of joining EU	Date of joining ERM II (target)	Target for EMU entry
Cyprus	2004	May 2005	2008
Malta	2004	May 2005	2008
Poland	2004	Not established yet	Not established yet
Czech Republic	2004	Not established yet	2012*
Slovakia	2004	November 2005	2009
Hungary	2004	Not established yet	2011*
Romania	2007	2012	2014

Note: *Not before this date
Source: www.bnr.ro

From one of the latest economic data and survey, available information confirm that the euro area and its major trading partners are undergoing an extended period of significant economic downturn, and that accordingly, both external and domestic inflationary pressures are diminishing. In the euro area, inflation rates are expected to be in line with price stability over the policy-relevant medium-term horizon, thereby supporting the purchasing power of euro area households. Further deceleration in monetary and credit growth reflect and support these trends. Overall, the level of uncertainty remains exceptionally high, as economic activity throughout the world has weakened substantially, thus underlying the intensified and world-wide – broadened financial market turmoil.

The next difficult period the present executive has to implement some very ambitious strategically *objectives*, meant to recover the domestic equilibrium, but also to satisfy the convergence criteria:

- Severely cutting the public administration current expenditures, considering only the efficiency and the performance in the public sector and the planned social purposes –
- Allocation oriented to objectives with *multiplying effects* only, as to limit and compensate the reduction of the activity in the private sector during the economic recession –
- Implementing the *golden rule* of the public finances, i.e. the deficit should finance only public investments, while the current revenues should finance only the current expenditures –
- Public debt sustainability means that the foreign debt must be used only to stimulate and to support the economic growth –

- Approaching a *multiannual budgetary strategy* meant to plan and to realise reasonable medium-term public expenditures and also a target of 1 % to GDP deficit to be attained by 2012.

Considering the latest prognosis and our officials' data and bearing in mind the financial global crisis as well, Romania's situation is relatively difficult not from the point of view of the public debt, but of the government's deficit especially. Romania's FOREX are able to cover 10.3 months imports of goods and services, thus confirming the wise monetary measures adopted by NBR.

In a different manner is to be approached the public budgetary deficit that exceeded just the most pessimistic expectations and the context of the international turmoil also increases the difficulties to be financed and to support the growth, a totally unacceptable situation after several years of continuous high growing rate.

The present circumstances mean a crucial important moment where there is but one of the two possible ways to choose.

- Either to choose a **"U" economic evolution**, i.e. to sacrifice some FOREX now and simply jeopardizing our future development under an unexpectedly excessive rate of debt, or
- to choose a **"V" economic evolution**, meaning resorting to borrowing with a view to financing both deficit and credit activity, so that the economy could *jump* in a sudden development that might afford a sustainable budgetary deficit for relatively short time in the near future, without compromising its convergence chances to EMU.

Romanian officials have opted for the 2nd solution and a borrowing agreement with European Commission, European Investments Bank and International Monetary Fund was settled these days. Henceforth, a stand-by Agreement for about 2 years was discussed upon and accepted between Romania and these international financial institutions, so that the economic engines could be restarted, credits could be taken and negative impact of the crisis could be mitigated. The agreement that was negotiated upon sets also Romania's obligation to reform certain economic activities, wages and pensions systems, to finance the infrastructure building and to sustain the exchange rate, as to control the external balances as well.

Moreover, it is worth to mention that Romania's specific conditions ensured, therefore, better terms of negotiations too, referring to the income flat tax, the VAT value and other public expenditures necessarily oriented to social purposes.

8. CONCLUSIONS

As the financial tensions have further impact on the global and domestic economy, persistent weakness is also foreseen over the coming quarters in the euro area, despite some recent tentative signs of stabilisation in some survey data. However, their historically low levels require confirmation on a broader basis. The significant policy measures that have been decided upon over recent months are to deal with the financial

turmoil and its adverse consequences. They should help to restore trust in the financial system and to ease constraints on credit supply both to companies and households.

In order to ensure that such measures effectively support a sustainable recovery, it is of utmost importance that they remain focused and temporary in nature, so as to maintain a stability oriented and medium-term perspective in macroeconomic policy-making.

*

Either budgetary deficit and public debt contain the quintessence of the convergence efforts in taking into account the public finance, since both indicators exhaustively mirror the government's administration and interventionism, and reflect its practices and macroeconomic policies strategies. At the same time, they contain information and facilitate estimation and prognosis concerning not only that country's estate and future, but the Union's stability and future as well, since it represents an integrated system of many countries, a unitary whole of common goals and interests.

*

In the difficult period that follows, the present Romanian executive has to implement some very ambitious strategically *objectives*, not only meant to recover the domestic equilibrium, but also to satisfy the nominal and real convergence criteria, as a duty to respect the commitments assumed by signing the Maastricht Treaty. Thus, Romania is constrained – but now, also able – to take firm steps for preventing a fatal slipping from the sustainable development path. Therefore, it ought to reformulate the entire economic policies, aimed not only to maintain balanced the macro variables, but also giving priority to the strategic target that EMU entry requires.

REFERENCES

- Afonso, A.; Sousa, R. M. (2009), „*The Macroeconomic Effects of Fiscal Policy*”, ECB – Working Papers series, No. 991;
- Fagan, G.; Gaspar, V. (2008), “*Macroeconomic Adjustment to Monetary Union*”, ECB – Working Papers series, No. 946;
- Afonso, A.; Rault, Ch. (2008), “*3 – Step Analysis of Public Finances sustainability – the Case of the European Union*”, ECB – Working Papers series, No. 908;
- Lipinska, A., “*The Maastricht Convergence Criteria and Optimal Monetary Policy for the EMU Accession Countries*” (2008), ECB – Working Papers series, No. 896;
- Iancu, A., “*Economic Convergence Applications*” (2007), 2nd Part, edited in the review “Romanian Journal of Economic Forecasting”, No. 4;
- Georgescu, G. (2007), “*Current Account Deficits and Implications on Country Risk of Romania*”, edited in the review “Romanian Journal of Economic Forecasting”, No. 4;
- Chateau, J. (2002), “*When are Structural Deficits Good Policies?*” Working Paper in CEPIL – Centre d’Etudes Prospective set d’Information Internationales;
- Fisher, S., Gelb, A. (1990), “*The Transforming Processes of Socialist Economy*”, an International Monetary Fund Survey;
- “*The European Union and the Commonwealth of Independent States*” - Statistical comparison, EUROSTAT - 2008 edition;
- ECB, Convergence Annual Report, May – 2008
- ECB – Monthly Bulletin Jan-Feb – 2009
- <http://ec.europa.eu/eurostat>
- www.bnr.ro
- www.guv.ro