ROMANIA'S EUROPEAN MONETARY INTEGRATION – ACTUAL STATUS, COSTS AND BENEFITS

Anca TĂNASIE, Lect., PhD
University of Craiova

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Abstract: For Romania, the EU accession and the European symbols – such as the EURO currency – represent both the integration into a strong and efficient economic system, but also the guarantee for real democratic values. Romania has expressed a real and strong attachment for the European Union, its symbols and values. The focus of this paper is directed towards the actual economic and monetary situation in Romania, on its way to the single European currency. Economic conditions have generally improved, but some problems still persist. Reality is now different considering the inflation growth and the important deviation from the target, and recently, the exchange rate fluctuation and the national currency devaluation. Romania has had a unfavourable history concerning inflation and even exchange rate matters. The situation is unfortunately not yet stabile, inflation is still an important issue, the exchange rate is still fluctuant, and the National Bank of Romania is still confronted with the situation of having to deal with monetary problems, but which in fact have an economic and productive explanation and cause. Finally benefits and costs of the EMU accession for Romania are sinthetized and explained according to the previous description of the economic and monetary situation

Romania's Actual Economic Status and the Convergence Process

During recent years, Romania's macroeconomic condition is improving. That is a fact proven by the statistics of the National Bank of Romania and by the National Institute for statistics, and most of these positive results have been achieved on the way and aiming the convergence to the Euro-zone. The last four years displayed a good track record in consolidating the macroeconomic stability while lowering inflation.

The GDP growth was of 7.7% in 2006 ,based on increases in final consumption by 11.5% (private consumption grew 12.6%) and in investment by 16.1%. The projection for 2007 is at a level of 6.5%. The inflation significantly decreased from 8,6% (dec.2005/dec.2004) to 3,77% (apr.2007/apr.2006) in terms of the annual rate. In terms of the average annual rate, the inflation calculated as the CPI (Consumer Price Index), significant improvements are also present – a lowering form 9,0% in 2005 to 6,56% in 2006. Prudent fiscal and monetary policies supported the progress in macroeconomic stabilization and established the basis for robust economic growth. In 2006 the overall fiscal deficit was under the target of 1.5% of GDP. Fiscal policy has continued to support disinflation and to contain the current account deficit within a sustainable ceiling.

Starting with January 1, 2005, a major fiscal reform package was applied in Romania following the adoption of the Government Emergency Ordinance No. 138/30.12.2004 (O.J. No. 1281/30.12.2004) for modifying and amending the Law No. 571/2003 regarding the Fiscal Code. The most important measure is the introduction of a flat rate of 16% for corporate profit tax (as compared to 25% so far) and for personal income tax (as compared to a progressive tax system with rates ranging from 18% to 40%).

The main reasons for the new fiscal regime were the need to consolidate the foundations and mechanisms of the free market economy, to support the private entrepreneurship by creating a more favorable environment for investments and generally for business, to boost employment and to simplify the fiscal procedures. The tax relaxation was also necessary because the relatively high tax burden generated rigid developments in the past, hampering the restructuring of the domestic demand, while keeping hidden parts of the economy away from the national accounts.

Thus, the Fiscal balance for 2006 was -1.7% of GDP, and the forecasted and programmed rate for 2007 is -2.8% of GDP.

The monetary policy was tightened and bank supervision strengthened. The National Bank of Romania has continued to monitor credit growth and implement decisive measures to contain it as needed for both macroeconomic and prudential reasons. The National Bank will proceed with the full liberalization of the capital account and with the national currency denomination. The following elements act as main components of the new monetary policy strategy:

- direct inflation targeting (August 2005)
- full liberalisation of capital account and full
- convertibility of domestic currency (September 2006)
- redenomination of domestic currency (July 2005)
- completion of implementation of the Electronic Payment System (October 2005)

The current account deficit reached in 2006 about 10 bln. EUR, 44,8% higher than in 2005; (10,3% din PIB), 90,8% covered from foreign direct investments. At the same time, FDI (Foreign Direct Investments) for 2006 reached 9,1 bln. EUR, 72,8% more than 2005. The following table presents a brief insight of Romania's most recent macroeconomic indicators.

Table 1

Macroeconomic Indicators for Romania

	2005	***2006***	***2007 (estimations)***
Inflation (%)	9.0	6.56	-
GDP growth (%)	4.1	7.7	6.5
Current account deficit (%GDP)	8.7	10.3	-
Foreign direct investment(bln. EUR)	5.2	9.1	-
Fiscal balance (%GDP)	-0.8	-1.7	-
International reserves(bln. EUR)	18.3	22.9	23.2
Rating		S&P: from "positive" to "stabile" due to political tensions Fitch: from BBB- to BBB Moody's: from A2 to A1	

Source: National Bank of Romania

One of the main pillars of the Government economic program is consolidating the business environment. In this respect the following measures were announced: amending the Labor Code after having consulted the social partners (estimated end of process – July 2005); amending the law on Economic and Social Council and the Law on employers associations; introducing new measures for the SMEs set-up and development; continuing the process of decentralizing the public administration; enhancing the professional associations status .

These measures are complemented by a no tolerance attitude to corruption and fiscal evasion. The financial discipline, including the enforcement of the bankruptcy procedures, will be the main principle of the Government economic strategy.

On the back-ground of the serious improvement in the macroeconomic situation of the country, Romania has also proven progress in the fulfillment of the nominal convergence – the Maastricht criteria.

The Maastricht criteria highlight a series of economic targets whose achievement in fact envisage both nominal and real convergence in the sense of the functioning of the monetary policy in order not to bring disfunctionalities inside the EMU. This set of criteria is also applicable to the actual candidates – from which Slovenia has won the top position and became a member of the Euro-zone from January 1st 2007. The purpose of this analysis to point out the extent in which the group of candidates is uniform from the point of view of the stability of the orientation.

First, we must study the degree of compliance with the criteria, and second the commitment to the Euro adoption process. The following table presents a comparative situation of the nominal convergence criteria for the candidate countries to the accession to the Euro-zone. (* forecast)

Table 2

The Maastricht Criteria and the Candidates

	Budget deficit (%GDP)	Debt (%GDP)	Exchange rate fluctuation (%/ -15%)	Inflation (%)	Interest rate
	2007*	2006	2006	2007*	2007*
Bulgaria	-2.4	29.9	0.60	8.4	3.9
Czech Republic	-3.0	30.6	5.52	2.8	4.25
Estonia	2,6	34.0	0.00	4.4	4.7
Hungary	-5.7	67.5	10.59	3.7	8.5
Latvia	-1.0	10.7	1.00	14.1	7.5
Lithuania	-1.2	18.4	0.00	3.8	8.52
Poland	-2,2	42.4	7.98	3.5	6.25
Romania	-2,4	12.4	8.15	6.56	5.75
Slovakia	-3.4	33.1	10.75	4.4	4.3

Source: ECB, Romanian National Bank

In order to make a brief, but consistent and relevant analysis of the real convergence we shall focus exclusively on the use of the real convergence indicator – the GDP per capita in euros for all the candidates mentioned above, including Romania.

Table 3

The Real Convergence and the Candidate Countries

	GDP per capita (PPS)%, EU27=100
	2007*
Bulgaria	38.3
Czech Republic	81.4
Estonia	72.3
Hungary	65.0
Latvia	58.9
Lithuania	60.0
Poland	54.6
Romania	40.5
Slovakia	67.8

Source: ECB, Romanian National Bank,

Based on the macroeconomic data presented, and on the simulation made, the conclusions offered by this study may be resumed to the fact that Romania has made progress. But that is not all, apart from the progress in the macroeconomic indicators, and from the serious engagement to structural reforms, the economic status and position must not be treated in an isolated manner. That is why the present study leaves from the general macroeconomic situation and makes a comparative analysis for the Romanian case amongst the other candidates to the accession to the Euro-zone. This accession, will probably consist, as recent timetables show in certain “enlargement waves”, and thus the absolute economic performance is not enough, we need to also consider the relative one.

Costs and Benefits of the EMU Accession

The foreseen accession to the ERM II by Romania is placed in time for 2012 in order to ensure total nominal convergence and significant progress in the real convergence. The Euro adoption moment is projected to the 2014 time horizon. The membership in the common currency area entails both benefits and some costs. The potential real costs stemming from the fulfillment of the inflation criterion should be taken into account. These costs are short-term only.

Synchronization of business cycles between Romania and Euro-Zone show that asymmetric shock exposure is not very high. One may expect that it will be even lower following the euro area entry. First, increasing trade integration between Romania and euro-zone countries will reduce the vulnerability of the Romanian economy to asymmetric shocks. Enhanced trade integration leads to an enhanced convergence of business cycles. Second, after adopting the euro synchronization of the business cycles between Romania and the euro area should also be reinforced by adjustments in monetary policy, since Romania’s entry to the EMU will entail the elimination of the potential sources of asymmetrical shocks originating in the differences between interest rate policies conducted by the NBR and the ECB. Finally, euro adoption in Romania should contribute to increasing flexibility of real wages, translating into a more effective mitigation of asymmetric shocks. Summing up, it can be stated that the euro adoption itself will result in further integration and convergence between the economies of Romania and euro zone, thus facilitating the absorption of asymmetric shocks and lowering the cost of giving up autonomous monetary policy. This phenomenon is known as endogeneity of OCA criteria.

The membership in the common currency area is associated with various benefits. These benefits by far exceed the costs. First, the elimination of the exchange rate excludes the possibility of a currency crisis, what in turn results in foreign currency debt rating upgrade. Second, giving up the domestic currency will contribute to the decline in domestic interest rates due to the elimination of exchange risk premium. As a consequence, the cost of capital decreases, which leads to increasing domestic investment. Fourth, the elimination of the foreign exchange rate volatility results in exchange rate uncertainty reduction, hence in the international trade expansion.

The economy will benefit from higher FDI inflow and increased competition in the goods and services market. Stronger competition induced by the monetary union fosters better allocation of labour and capital and increases pressure on a more efficient use of existing resources, which boosts factor productivity.

The EURO offers prospects for higher output in the long run. Basing on the assumption that the long run effect of the euro can be channelled through either interest rates or international trade, they can be reckoned to be around 4-7%. All other factors adding to further output growth are not included in the estimation. Delay in euro adoption, on the other hand, is associated with risks.

Concluding, EURO is a new beginning, an opportunity, faster economic growth, a positive economic development.

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