

NOMINAL CONVERGENCE IN ROMANIA

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Abstract: The recent EU enlargement process brings in attention the next obvious step, entering European Monetary Union. For the two new EU members, as well as for the ten entered in 2004, adopting the euro as national currency seems to be a priority objective, although it is not a choice, but a must. The enlargement is an opportunity to evaluate the Maastricht criteria for adopting the single currency. This paper evaluates the degree of accomplishing of the nominal convergence criteria by Romania. Even if the euro adoption is still far away from our country, we must concentrate in the next few years mainly in the catching-up process. The study shows that even we can fulfill the Maastricht Criteria, we should wait before euro adoption until we will reach the real convergence, for avoiding the asymmetric shocks.

Key words: European Monetary Union; ERM II; Euro; Maastricht Criteria; real convergence

1. Introduction

The accession to the euro area will represent a second step of great importance for Romania, after the accession in the EU at 1st of January 2007. The period 2007-2012 of preparation for the euro adoption represents a great opportunity to continue the reforms and reduce economic disparities, maintaining in the same time the macroeconomic equilibrium. If the accession to the euro area is itself a strategic objective of great importance, the schedule for euro adoption represents a timing optimization problem in which the speed should be dictated by a costs-benefits analyze with the following restrictions:

- a. the fulfillment on sustainable bases of the Maastricht criteria;
- b. the accomplishment of a satisfactory level of real convergence;
- c. reducing the participation in ERM II at the compulsory period of two years.

Starting from these ideas, this paper analyses the conditions to be accomplished as well as the main options of economic policy in order to fulfill nominal convergence criteria and the degree of achieving of this nominal convergence criteria by our country.

Romania differentiate from the majority of the new members candidates at euro adoption through the fact that it does not have problems concerning the budgetary deficit and the total public debt, namely the fields where other countries must make the most radical adjustments; instead, the inflation and interest rate levels still represent a reason of worry for our country. This asymmetry will probably impose a different strategy in the period of participation in ERM II.

2. Budgetary deficit

Romania's performance concerning the budgetary deficit is satisfactory, as the 2006 deficit, calculated in accordance with the ESA95 methodology, harmonize comfortably with the Maastricht criterion, of 3 percent, superior performance comparing with other countries members of the EU since 2004.

Table no. 1: Budgetary Deficit (-) / Surplus (+) (% of GDP)

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

Source: EUROSTAT, National Banks

3. Public debt

Romania's performance concerning public debt is also very good; the actual level of below 20% of GDP is much lower than the threshold of 60% of GDP set by the Maastricht Treaty. At the end of 2005, the government debt, calculated in accordance with the ESA95 methodology, represented 15.9% of GDP, out of which the domestic debt was 3.2% and the foreign debt was 12.7%. At the end of 2006 this indicator reached the level of 12.8% of GDP.

Table no.2: Public Debt (% to GDP)

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

Source: EUROSTAT, National Banks

Although the fiscal position of our country – if we analyze the two indicators – is comfortable now, there are elements that must be taken into consideration in order to maintain this evolution in the future. The quasi-fiscal deficits and high public expenditures which must be budgeted in the future oblige to maintain the present public deficit in more close limits than the ones set by the Maastricht Treaty.

4. Inflation rate

There are also criteria where Romania's position is not that comfortable. The most important of them is the one concerning the annual inflation rate, which was of 6.56 percent in 2006.

The causes of this situation could be found in the late ending of the prices' liberalization process, as well as in adopting a gradually reducing inflation strategy, together with the attached costs and benefits. In Romania, the last "wave" of prices and exchange rate liberalization took place in 1997, while in other countries more advanced in transition, this process took place in 1992-1994. Also, the strategy of reducing the inflation gradually, with nearly a quart from the previous year's value, initiated in 1999, was preferred to a radical solution (of the currency board's type) from the following reasons: the importance still big that Romania's external creditors continued to give to the current account deficit; the necessity of alignment to the European prices, tariffs and incomes starting from lower levels than the other countries in transition; the concern that through a fast reducing of inflation, due to adverse selection and moral hazard phenomena, the developed part of the economy should suffer more than the undeveloped one. Of course, the choice of this strategy also involved costs, especially regarding the foreign investors' under-trust in an insufficiently stabilized macroeconomic environment.

At the end of 2006, the year on year inflation rate declined to a historical minimum level of 4.87 percent, with a more obvious deceleration in April, due to a base effect, and also in July and September, when quarterly changes in CORE 1 inflation highlighted a clear slowdown in the pace of price increases. The more intense disinflation process was the result of an appropriate monetary and fiscal policy mix, improved market expectations regarding the sustainability of the disinflation process and increased competition in the retail sector.

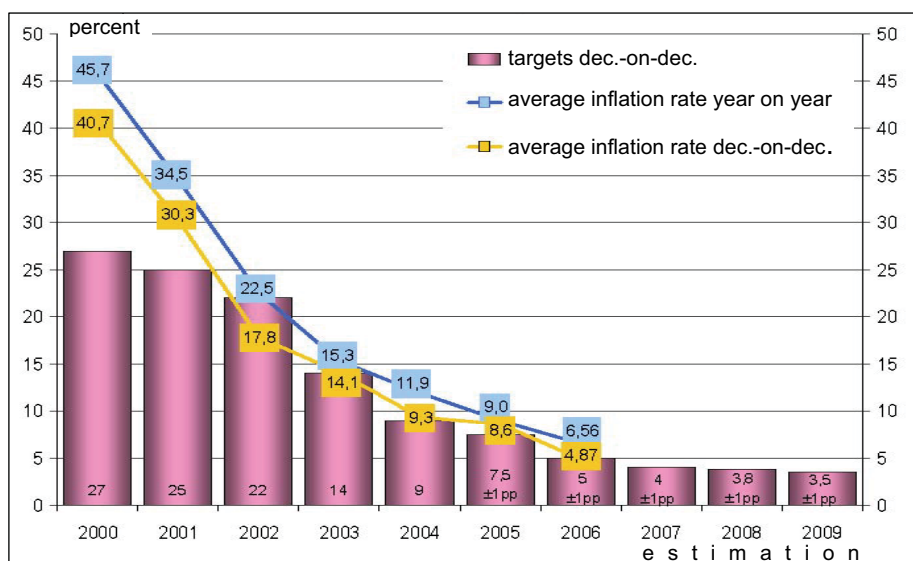


Figure no.1: Inflation Rate (CPI) 2000-2009

For 2007, the inflation target was set at 4% dec.-on-dec. with a tolerance band of one percent point in either direction; for 2008, the central target will become 3.8% dec.-on-dec., with the same margin of tolerance, and, over the medium term, the inflation targets will be set in accordance with the path necessary for maintaining the disinflation process in accordance with the convergence criteria.

5. Long term interest rate

Closely tied to the inflation criterion is also the long term interest rate criterion. The interest rate at the last governmental bonds issue on 10 year term, realized in august 2007, was of 6.73 percent. Of course, as the disinflation process will strengthen, and the economic agents will be convinced of its sustainability, this criterion will have chances to be fulfilled.

6. Exchange rate stability

The fifth nominal convergence criterion, regarding the exchange rate stability, depends on the fulfillment of the inflation rate criterion. Since inflation was brought to a one finger value, exchange rate began to show a degree of stability compatible with the fulfillment of this criterion. In the period 2005-2006, the maximum daily appreciation/devaluation compared with the last two years average of the RON/EUR exchange rate was of +10.0%/-6.1%, values within the band of fluctuation set by ERM II.

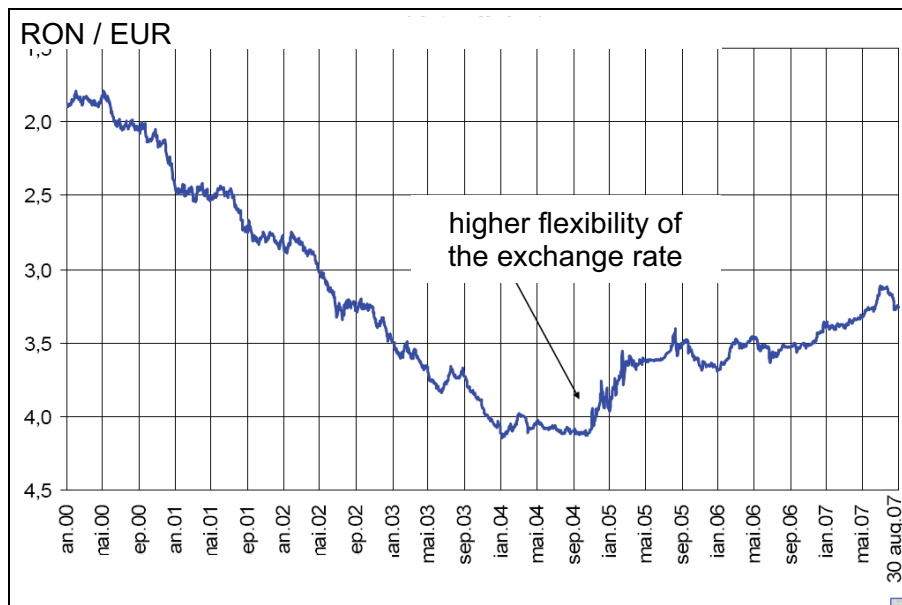


Figure no.2: Exchange Rate (daily data)

It must be specified that the relationship between the inflation rate and the exchange rate is biunivocal, in the sense that they mutually intensify. To put it differently, the much stable exchange rate is not only the result of a lower inflation, but a lower nominal depreciation (or – meaning the same thing – a higher real appreciation) may lead to a decrease in inflation rate. Therefore, a very important conclusion is that a real appreciation of the exchange rate intensifies the disinflation process. However, this real appreciation cannot be arbitrarily imposed, without observing the “gold rule” according to which the increase in labor productivity (seen as a stimulatory factor of external competitiveness) must be every year higher or at least equal with the sum between the real appreciation of the national currency and the real increase of the average wage (seen as inhibitor factors of external competitiveness).

7. Conclusions

The level of achievement of nominal convergence criteria for Romanian economy is summed up in the following table:

Table no. 3: Achievement of Nominal Convergence Criteria by Romania (2006-2007)

Nominal convergence indicators	Maastricht criteria	Romania	
		2006	2007
Inflation rate (percent, annual average)	<1.5 % above the average of the 3 most performers members of the EU (2.8 percent)	6.56	4.0 (estimation)
Long term interest rate (percent per year)	<2 % above the average of the 3 most performers members of the EU (6.2 percent)	-	6.73
RON/EUR exchange rate (maximum daily appreciation/devaluation compared with the last two years average)	±15 percent	+10/-6.1	+10.1/-6.7
The budgetary deficit (percent of GDP)	Below 3 percent	1.9	3.2 (2.8 according to the IMF)
The public debt (percent of GDP)	Below 60 percent	12.4	12.6

The transition to the euro area mustn't be needlessly accelerated, and the adoption of the single European currency must not be treated as a simple goal. Besides reaching the nominal convergence objectives, all economic policies must have as objective the achievement as soon as possible of the real convergence. Romania must not hurry its accession to the euro area, as our country has to cover important gaps. The accession in the ERM II mechanism is foreseen for 2012, so that the accession to the euro area may occur in 2014 – admitting that during the whole period the catching-up process is taking place.

The fixation of the year 2012 as target-date for the accession in the ERM II mechanism must be understood and treated as an extra opportunity for the real convergence of the economy and not as a *time-out* that would allow untimely relaxation of the macroeconomic policies followed by the authorities.

The period between the accession to the EU and the accession in the ERM II must be wisely used for deep economic reorganization and for realizing some investment programs capable of reducing, in the shortest time, the gap which separates us from the present standards of the European Union.

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