

ROMANIA'S PERFORMANCE IN THE EMU ACCESSION PROCESS

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Abstract: Following Romania's accession to the European Union, the greatest challenge facing economic policy is compliance with the criteria for joining Economic and Monetary Union. The economic policy decision-makers must consider the convergence criteria, in order to be able to comply with them at the lowest possible cost. Romania is a little behind the other countries in what regards the convergence criteria, except of the government finances criteria. With the entrance in the Euro zone set to 2014, it has still got time to meet them, but the fact that it is among the last in the EU should be a worry.

Key words: European Union, convergence, stability, performance, catching up

1. Introduction

The Treaty on European Union represents a new stage in European integration since it opens the way to political integration. The Treaty introduces the concept of European citizenship, reinforces the powers of the European Parliament and launches economic and monetary union (EMU). Besides, the EEC becomes the European Community (EC). The EMU puts the finishing touches to the single market. It can be described as an advanced stage of economic integration based on a single market. It involves close co-ordination of economic and fiscal policies and, for those countries fulfilling certain conditions, a single monetary policy and a single currency – the Euro. Entry into the euro zone will mean lower risk premium and interest rates, as well as lower transaction costs, along with a say in shaping the ECB's monetary policy, the independence from which becomes more imaginary than real once a small country has *de facto* integrated into the economy of the euro zone.

The Maastricht criteria for accession to the Euro area can be difficult for any economy to achieve. For poorer economies which are catching up to the living standards of the wealthier EMU members, the challenges are magnified. Catching-up economies are those that are narrowing the per capita income gap vis-à-vis wealthier economies, by investing in better human and physical capital and by adopting more efficient production processes. As the productivity gap narrows it is natural to expect the price level gap to narrow also, reflecting the gradual convergence of living standards to those of Western Europe. However, this process poses particular challenges for the catching-up countries' goals of meeting the Maastricht criteria of low and stable inflation together with stable exchange rates. (Brook, 2005)

The new Member States, which have joined the EU in 2004 and 2007, are expected to enter the Euro area over several years, as they fulfill the necessary conditions. The process started on 1 January 2007 when Slovenia became the first EU Member State from the 2004 enlargement to adopt the Euro. Starting 2008 Cyprus and Malta have also joined the Euro Zone. Sweden is expected to join the Euro area in the future, but has not yet qualified.

This paper is trying to compare Romania's performance regarding the economic criteria, set by the Maastricht Treaty, as well as the real convergence criteria meant to show the standard of living within the countries, with the group of countries which have joined the EU in 2007¹⁶⁸, and of those that have joined it in 2004¹⁶⁹.

¹⁶⁸ Romania and Bulgaria

¹⁶⁹ Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, Slovakia

2. The nominal convergence criteria

2.1. Price stability

The price stability criteria implies that the inflation rate of a given Member State must not exceed by more than 1½ percentage points that of the three best-performing Member States in terms of price stability during the year preceding the examination of the situation in that Member State. Anne-Marie Brook very well notes that this definition of the reference value makes fulfillment challenging for three reasons.

First, to the extent that the Balassa-Samuelson¹⁷⁰ (BS) effect is significant, it may create a more challenging goal post for catching-up economies than it did for the core EMU economies, resulting in the boxer effect¹⁷¹. Second, even for countries without a significant BS effect, the definition of the inflation reference value creates uncertainty about the definition of “best performing” in the context of price stability. Initially the “three best-performers” were simply identified as the three EU countries with the lowest inflation rates. In 2004, however, the Commission decided to exclude Lithuania on the basis that “countries with negative inflation are not considered to be best performers in terms of price stability” (European Commission, 2004). This however raises the question of whether countries with positive, but very low, inflation rates would be considered best performers. Finally, the third reason is this definition provides a moving target for compliance with the criteria, since the composition of countries that meet the “best-performing” criteria will change over time, and their inflation rates cannot be predicted with certainty. (Brook, 2005)

It can be observed that in most of the countries that have joined the European Union, both in 2004 and 2007, there is an ascending trend. The countries that are an exception are Slovakia, Slovenia, Cyprus, Malta and Romania. In what regards the reference value of the inflation rate we can see that it is very close the Euro zone average. At the end of n2004, after the EU accession, the Czech Republic, Estonia, Hungary, Lithuania, Latvia and Poland have seen a growing inflation rate with 1.64 to 3.55 percent, and has been growing ever since. Excluding the states that have already joined the Euro zone¹⁷² the others are still a little far from the levels in the Euro area. Latvia has the highest inflation rate, followed closely by Hungary, Bulgaria and Estonia.

This trend reflects the global increase in energy prices, which has been affecting consumer prices. In some countries, recent inflation developments have been influenced by increases in food prices, which have begun growing at a faster rate in 2006, following very subdued rises or declines in 2005. Inflationary pressures have been reinforced by a combination of rapid domestic demand growth – supported by strong real income and credit growth feeding through into household consumption – in many of the countries examined and EU entry-related increases in indirect taxes and administered prices. In some rapidly growing economies, increases in unit labor costs have also contributed to inflation. By contrast, declines in tradable goods prices, such as the prices of clothing and footwear, suggest that a shift in import patterns towards low-cost countries is having a downward impact on inflation. (ECB, 2006)

Slovakia is one of the best performers in what regards the inflation criteria, along with Cyprus and Malta. Its inflation rate has dropped from 8.43% in 2003 to 1.89% in 2007. While it has seen sharp rise in 2006 to 4.26% from 2.8% in 2005, it has come back on track dropping in 2007 to 1.89% and meeting the Maastricht criteria for inflation rate.

¹⁷⁰ The Balassa-Samuelson effect implies that the catching-up economies have higher *steady state* inflation rates than do the wealthier economies of the Euro area. Because of this, it has been argued that the Maastricht criterion on inflation may be inconsistent with the catching-up process. One concern is that accession countries may be forced to achieve the required inflation reduction by allowing greater nominal exchange rate appreciation, which could lead to a loss of competitiveness and risk attracting speculative capital flows. Another concern would be that an accession country may be forced to deliberately slow the economy below its potential growth rate, leading to a loss of welfare.

¹⁷¹ The boxer effect states that the candidate country will do whatever is required to squeeze down inflation prior to accession, only for repressed pricing pressures to re-emerge once it has joined the EMU (Szapáry, 2001)

¹⁷² Slovenia in 2007 and Cyprus and Malta in 2008

	Czech Republic	Estonia	Hungary	Lithuania	Latvia	Poland	Slovakia	Slovenia	Cyprus	Malta	Bulgaria	Romania	Euro area	Average reference rate
2007	2,95	6,74	7,93	5,82	10,08	2,6	1,89	3,8	2,2	0,7	7,57	4,91	2,1	2,8
2006	2,09	4,44	4,03	3,79	6,57	1,27	4,26	2,54	2,25	2,58	7,42	6,61	2,2	3
2005	1,6	4,11	3,48	2,66	6,9	2,18	2,8	2,47	2,05	2,53	6,04	9,07	2,2	2,8
2004	2,55	3,03	6,77	1,16	6,19	3,59	7,47	3,65	1,9	2,72	6,15	11,89	2,1	2,4
2003	-0,07	1,39	4,68	-1,08	2,94	0,71	8,43	5,7	3,98	1,94	2,35	15,27		

Table 1. HICP - Overall index, Annual average rate of change, neither seasonally nor working day adjusted, Source: Eurostat, own calculations

Looking back over a longer period, HICP inflation in Cyprus has been contained, with only occasional periods of relatively high inflation. This long-term inflation performance reflects a number of important policy choices, most notably the long-standing tradition of pegged exchange rate regimes, which dates back to 1960. In Malta, inflation has been relatively stable, fluctuating mostly between 2% and 3% over the chosen period of reference. The fact that inflation has remained relatively stable over a long period reflects a number of important policy choices, most notably the decision to maintain a pegged exchange rate arrangement since Malta became independent in 1964, for most of the period against a basket of currencies. Since 2 May 2005, the Maltese lira has been pegged to the Euro.

In what regards Romania, unlike the other states that have recently joined the EU, it has seen a clear disinflation trend during the chosen period, mainly due to the monetary policy adopted by the Central Bank. However it is still higher than the Euro area rate, about 2.81% difference in 2007, and higher than the average reference rate required by the Maastricht criteria. The upward trend in the projected annual inflation rate is expected to continue in 2008 Q1 followed by the resumption of disinflation and its acceleration towards end-2008. The NBR reiterates that it will use all available instruments at its disposal in order to resume as fast as possible, in a sustainable manner, the announced medium-term disinflation trajectory, the risk-management strategy employed in the configuration and implementation of monetary policy requiring that inflation targets¹⁷³ be attained over the medium run with the conservation of main macroeconomic equilibrium while avoiding the worsening of existing disequilibria. (NBR, 2008)

According to economic analysts, in almost all countries, the inflation rate is expected to rise in 2008, due to the recent world economic downturns. This would probably affect both the Euro area countries and the derogation countries as well. A CESifo study puts the expected inflation rate for the first quarter of 2008 at 2.5% in the Euro area and at an average of 5.1% for the new EU members, i.e. 2004 and 2007 accession. (CESifo, 2008)

2.2. Long-term interest rates

The nominal long-term interest rate must not exceed by more than 2 percentage points that of the three best-performing Member States in terms of price stability. According to guidelines, interest rates should be based on secondary market yields. However, for some countries, i.e. Cyprus and Lithuania the interest rates are based on primary market rates. For Estonia, which has a very limited government debt, harmonized ten year government bonds following the common statistical framework could not be identified. As a best indicator, it was used the average level of interest rates on new loans to enterprises and households with maturity over 5 years.

The highest interest have been reached by Hungary and Romania, i.e. 7.12% and 7.49% in 2006, while in the Euro area the rate has dropped to 3.83%. However all the other countries taken into consideration have reached interest rates above those of the Euro area. In what regards the reference value it reached 6.2% in 2007

In Romania the interest rate from the last 10 year government bonds issue, in august 2005, was 7.49% and in the last 5 years government bond issue, in march 2007, the interest rate was 7.03%.

¹⁷³ 3.8% in 2008 and 3.5% in 2009 (dec/dec)

2.3. Exchange Rates

ERM II is a system designed to avoid excessive exchange-rate fluctuations between the participating currencies and the Euro that might disrupt economic stability within the single market. The Member State must have participated in the exchange-rate mechanism of the European monetary system without any break during the two years preceding the examination of the situation and without severe tensions.

Conceptually, the ERM-II was designed to serve as a testing ground for the central rate as well as for the sustainability of convergence in general. In other words, the framework has been designed to help in identifying any potential misalignments in the central parity that have not been detected before. If the exchange rate remains very close to the central rate during ERM-II membership, and if the other Maastricht criteria are met, then this is seen as a positive sign that sustainable convergence has been achieved. Catching-up countries do not easily fit this framework, in its simplest form, since a significant productivity gap is likely to require some real exchange rate appreciation during the course of ERM-II participation.

Brook considers that for economies with floating exchange rates, this framework presents the national authorities with a number of challenges. First, although the central rate should ideally be set as close as possible to the estimated equilibrium level, there is considerable uncertainty about where the equilibrium level is. Second, there is a risk that speculative capital flows could push the exchange rate to an uncompetitive level. Finally, some appreciation of the nominal exchange rate within ERM-II may be necessary, in order to achieve some real exchange rate appreciation without sacrificing the inflation criterion (Brook, 2005). If a catching-up economy has a significant productivity growth differential with respect to that in the Euro area, then some appreciation of the real *equilibrium* exchange rate will occur over the period of participation in ERM-II. Given the inflation objective, this may require some nominal exchange rate appreciation. Fixed exchange rate regimes with perfect capital mobility are known for their weakness in the face of speculative attacks. For the ERM II, such intrinsic weakness may be worsened by possible “convergence plays”. Such plays arise when agents, anticipating economic growth in a country with a fixed exchange rate regime, invest massively in the economy, being attracted by high rates of return. But when such investments are short term, any turnaround in expectations may reverse the play and trigger currency depreciation.

In what regards the appreciation of the currencies none of them exceeded the set rate of +15%, over the analyzed period while only the Latvian lats have depreciated with over 2.5% in 2004 and 2005, however still in the +/- 15% band. The Maltese lira has been participating in ERM II with effect from 2 May 2005. The central rate for the Maltese currency in ERM II was set at 0.429300 lira per Euro – the market rate at the time of entry – with a standard fluctuation band of $\pm 15\%$. The Cyprus pound has also been participating in ERM II with effect from 2 May 2005. The central rate for the Cyprus currency in ERM II was set at 0.585274 pounds per Euro – also the rate at which the pound was linked unilaterally to the Euro since the beginning of 1999 – with a standard fluctuation band of $\pm 15\%$. The Slovenian tolar has been participating in ERM II with effect from 28 June 2004. The central rate for the Slovenian currency was set at 239.64 tolar per Euro, with a standard fluctuation band of $\pm 15\%$. Since joining ERM II the tolar has traded close to its central rate and Slovenia has not devalued its currency's central rate against the Euro on its own initiative and has maintained a rather stable Euro exchange rate.

Between 2004 and 2006, the Hungarian forint did not participate in ERM II but traded within a $\pm 15\%$ fluctuation band around a unilaterally set central rate of 282.36 forints per Euro. In this period, the forint was rather stable until February 2006, before being repeatedly subjected to depreciation pressures. From early 2006 the Hungarian currency traded against the Euro at a consistently weaker level than in November 2004 (ECB, 2006). With effect from 26 February 2008, the forint exchange rate has been floating freely vis-à-vis the Euro as a reference currency, with movements in the forint determined by the interaction between the forces of supply and demand.

The Slovak koruna has participated in ERM2 since November 2005. The exchange rate has remained within the 15% fluctuation band around the central rate, although much closer to the upper band than the lower band. In view of significant inflows of foreign direct investment followed by the progressive acceleration of economic growth and substantial appreciation of the estimated equilibrium real exchange rate, it was mutually agreed in March 2007 to revalue the ERM2 central rate for the Slovak koruna against the Euro by 8.5 % to SKK 35.4424. This step was meant to support the authorities in maintaining macroeconomic stability.

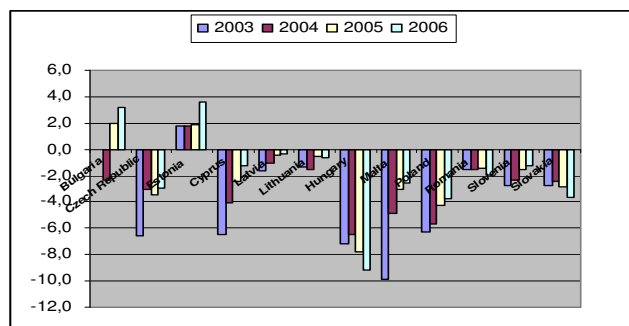
In what regards the Romanian leu the average exchange rate shows an appreciation of the currency over the chosen period. However, in the second part of 2007 and first part of 2008 the Romanian leu has clearly been depreciating, reaching a value of 3.72RON/EUR at the end of March 2008, compared to the average 3,3353 RON/EUR for 2007. The behavior of the RON exchange rate was shaped in December by the successive turmoil episodes on external money markets as well as by the rising global uncertainties related to the US sub-prime mortgage market crisis. Amid these developments, the domestic currency not only further depreciated versus the Euro, but the volatility of daily rates peaked at a two-year high, thus outpacing the similar indicator of other currencies in the region. The international environment had a large impact on the RON during the period under review as well, insofar as financial investors' decisions concerning placements on the domestic market were still influenced by the possibly excessive worsening of their perception of the current and short-term developments of the Romanian economy.

As uncertainties on world financial markets are likely to persist, the short-term behavior of the RON exchange rate is expected to come under the impact of possible shifts in the attitude of investors towards the domestic financial market. These mood swings will heavily depend on the reoccurrence of turmoil on world financial markets, but also on investors' increased sensitiveness to the developments and outlook for domestic economic fundamentals. (NBR, 2008)

2.4. Government finances

The Commission, when drawing up its annual recommendation to the Council of Finance Ministers, examines compliance with budgetary discipline on the basis of the following two criteria:

- *the annual government deficit*: the ratio of the annual government deficit to gross domestic product (GDP) must not exceed 3% at the end of the preceding financial year. If this is not the case, the ratio must have declined substantially and continuously and reached a level close to 3%. Among the analyzed countries, Bulgaria and Estonia do not have a deficit, but a rising surplus. The other countries either have a declining deficit, or a rising one, but however under 3%. Romania is one of the best performers regarding these criteria, with a very low deficit, but however rising in 2007, after the EU accession, to 2.5% from 1.9% in 2006. Hungary is one of the worse performers in what regards government deficit. After the EU accession in 2004, it has dropped by 0.7%, but starting 2005 it has risen to 7.8% and 9.2% in 2006. Slovakia also has a rising deficit, exceeding the 3% reference value in 2006, reaching 3.7%.
- *government debt*: the ratio of gross government debt to GDP must not exceed 60% at the end of the preceding financial year. If this is not the case, the ratio must have sufficiently diminished and must be approaching 60% at a satisfactory pace. Except for Hungary and Poland, all the other states considered have seen decreasing government debt after the EU accession. In this matter Romania is among the best performers, along with Estonia, Latvia and Lithuania. In Romania the government debt is under 20%, well under the 60% reference set by the Maastricht treaty. The main objective for the government debt management is its maintenance at sustainable levels and assuring the necessary resources for the government deficit financing, as well as the resources for paying off the debt at a low cost and a low risk level.



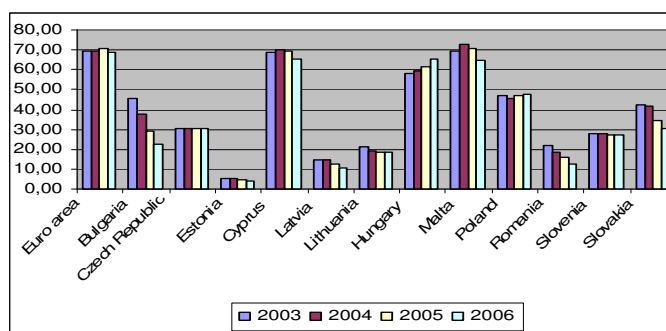


Figure 1. The annual government deficit and government debt, as percentage of GDP, Source: Eurostat and ECB Statistical Data Warehouse

3. Real convergence

The Maastricht Treaty does not mention explicit criteria in what regards the real convergence, which is meant to diminish the gap between countries in what regards productivity and prices, implying an income rise in catching up countries to the level in the developed countries in the EU. This criteria is best represented by the GDP per capita expressed in Purchasing Power Standard (PPS¹⁷⁴). It is defined as the value of all goods and services produced less the value of any goods or services used in their creation. The volume index of GDP per capita in PPS is expressed in relation to the European Union average set to equal 100¹⁷⁵. Basic figures are expressed in PPS.

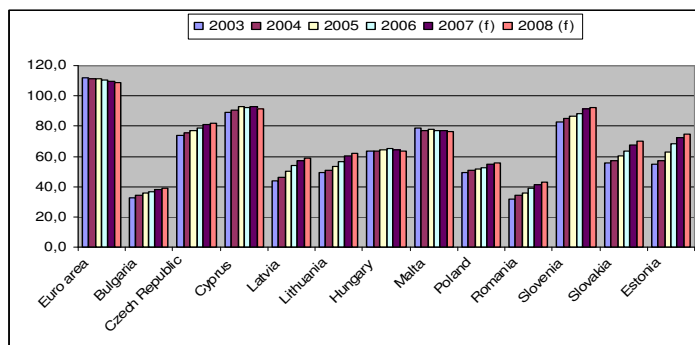


Figure 2. GDP per capita, Source: Eurostat, ECB Data Warehouse

One empirical observation in connection with the emerging countries is that, in parallel with the process of growth in per capita income, prices will also approach the levels of the more advanced nations, even though they are typically considered low during the early stages.

Regarding the situation of Romania, before the starting of the EU negotiations, the GDP per capita was 23.2% of the level in the EU, reaching 38.9% in 2006, before the EU accession and rising to 41.6 in 2007 (Eurostat forecasting). It is still expected to rise in 2008 to 42.6%. Even though, it is among the worse performers in the group of analyzed countries, along with Bulgaria. Despite this, all the countries have a lower level of GDP per head than the EU average. The best performers are Slovenia, Cyprus, reaching values of over 80%, hence getting closer to the EU average level. In all the countries it is clear that the GDP per capita has risen after the EU accession. This figures show that, all the recent EU entrants have still got a lot to work on the catching up process of the living standards in the other developed countries in

¹⁷⁴ eliminates the differences in price levels between countries allowing meaningful volume comparisons of GDP between countries.

¹⁷⁵ If the index of a country is higher than 100, this country's level of GDP per head is higher than the EU average and vice versa

the Union. Romania especially needs to rethink its strategy in this matter and speed up reforms that could narrow the GDP per capita gap vis-à-vis all the other countries in the EU.

4. Conclusions

In 2004 and 2007 twelve new countries joined the EU as Member States with a derogation on Euro area membership. This means that, while not yet adopting the Euro, they are committed to striving towards the eventual adoption of the Euro upon fulfillment of the four convergence criteria laid down in Article 121 of the Maastricht Treaty. The architecture of the EMU accession rule-book has been designed primarily for economies that are relatively homogenous with respect to the original EMU members. For such economies, sound macroeconomic and structural policies should make it relatively easy to achieve a stable exchange rate with respect to the Euro at the same time as low and stable inflation. The forthcoming monetary enlargement will go ahead in stages, subject to the trade-offs these countries will make between the demands of nominal convergence needed to join the Euro and their more general need to catch up economically.

This paper was meant to analyze Romania's level of the convergence criteria compared to the other recent EU entrants. The conclusion is that it still has a lot to catch up especially in what regards the inflation rate, interest rate and GDP per capita. The NBR states that it will use all available instruments at its disposal in order to resume as fast as possible, in a sustainable manner, the announced medium-term disinflation trajectory. The prerequisite of exchange rate stability is meant to strengthen the nominal convergence process and ensure convergence in expectations. Prior to the Euro zone entrance, exchange rate policies should smooth the development of the Romanian leu and act to prevent excessive deviation of the exchange rate from its perceived fundamental level. Unlike the inflation and exchange rate criteria, there is no reason why the fiscal criterion should be any more difficult for the catching-up countries to meet than it was for the original EU members. In this matter Romania is among the best performers in the group. Although both the deficit and government debt tend to rise in the last and following years, they are still below the reference rates and the other countries rates.

The main conclusion that can be drawn is that Romania is still among the last performers in the EU regarding the economic convergence criteria, which should be a worry for the authorities. They should try to increase the GDP per capita, while maintaining the disinflation trend and the government deficit to the required sustainable levels.

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Implicit criteria in what regards the real convergence, which is meant to be 2.5% from