THE BALANCE OF PAYMENTS' SUSTAINABILITY AND THE EUROZONE ACCESSION CONVERGENCE CRITERIA

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The main purpose of the balance of payments (BoP) is identified as representing the long term need of equilibrium and stability of the international payments and revenues. The purpose of this paper is to determine the factors that influence the balance of payments of a certain country, by using a rigorous classification that reveals the complexity of these factors. Our conclusions are very relevant, especially for countries like Romania, because, in order to achieve the external equilibrium, it seems that every county must adopt a mix of internal economic policies, and although theoretically this can be realised, sometimes in practice it can prove to be impossible on account of inability or refusing to combine the appropriate economic policies.

Keywords : balance of payments, sustainability, Euro area, convergence criteria, foreign direct investments, portfolio investments, external operations

JEL codes: F32, O11, F15, F33

The balance of payments purpose, functions and sustainability

The main purpose of the balance of payments is identified as being the long term need of equilibrium and stability of the international payments and revenues. This objectiv is determined by certain costs of certain imbalances between payments and revenues. The nature of the costs depends on the echange rate type of regime**.**

As in accountancy the balance of payments is always balanced, the imbalances registred refer to the main accounts' balance, the current account and the financial and capital account, except the National Bank reserves.

In otrher words, ***the balance of payments general imbalance*** *represents the sum of all comprising accounts' imbalances, according to its architecture*. Thus, the goods and services balance result, the income balance result and the current transfer result form the current accounts' imbalance. And the capital and financial account imbalance is given by the results of the financial account and capital account. So, every account's balance is obtained by adding all its comprising subaccounts' balances, and every subaccounts' balance is obtained by adding all its comprising items.

The external imbalance nominal value is given by balance of payments surplus or deficit and is reflected in the financial flows volume and sign. Thus, the balance of payments deficit represents the contiunuos negative and high value balance of all reserve assets.

According to the theory, the external imbalance appears only if the exchange rate is administred in a certain degree, because when the exchange rate is floating, every imbalance trend should be counteracted by a spontaneous shift of the exchange rate towards the equilibrium.

Therefore, the external balance represents the situation when the sum of the current account and the financial and capital account balance is zero. When this theoretical concept is transformed into an efficient policy, we can fiind many inconveniences, specially regarding the *period* considered when the balance of payments is analysed, *the period* when the balance of payments equilibrium forecasts to be obtained, *the balance of payments structure* and the *relation* between the internal and external balance.

The currents accounts' balance is one of the most important and most controversed ways of measuring the macroeconomic performances in a transition economy, and reflects the connection between the national economy and the rest of the world.

Regarded from a macroeconomic perspective, the current account balance reflects the impact of foreign resources inflow on the economic development and also draws the attention on a dangerous and unsustainable imbalance, determined by the cumulation of external debt as a result of the disparities between the available income and the economy's absorbtion capacity , and the difference between the national savings and gross investments[64] (key factors of economic growth), that transformes the saving - investment balance into the measuring instrument of the resource necesity generated by the economic evolution in a certain period of time.

A deficit resulted from the high level of investments can be sustainable only if the investments are directly related to capital formation and economic growth. *A deficit resulted from a low level of national savings* is more doubtful.

We consider that the current accounts' deficit sustainability is a complex concept that depends on several factors, like: the goods and services exports' growth rate compared with the one of the imports, the structure of exports, imports, government expenditure and national credits, and also the improving prospects of collecting budget revenues. And the governamental deficits sustainability has important consequences on the economy's external deficit sustainability. In transition countries the large governmental deficits are not covered by private savings, this situation being reflected in large current account deficits. Thus, budgetary deficits are largely covered by external loans , that can become a burden for the economy, if they are not used for financing fruitful investments. .

The foreign direct investments inflows perspectives influence the external deficit sustainability (a large percentage of FDI inflows could be helpful for covering the current accounts' deficit, but it must be considered that in the transition economies that have already finalised the privatization process, a drop of FDI inflows will probably be registred, FDI ensuring only the short term current account deficit sustainability) and also their economic destination. There are several long term FDI inflows perspectives, with positive effects on our country's competitiveness and supply expansion , including an export oriented production, on the account of Romania's production potential. Another important aspect refers to the phase of FDI: growth stage or the repatriation of profits stage. The hystorical experience shows that overall, FDI help the balance of payments, only in the first stage. In the second stage, their impact an the balance of payments becomes negative.

The current accounts' deficit also depends on the level, destination and structure of the external debt and on mantaining the posibility of covering the current accounts' deficit through external financing , ie the existence of a positive differential of the real interest rate and an external creditworthiness, and also of the international reserves evolution and balance, and of the tradable goods sector's developing degree.

The economy's capacity of sustaining the current accounts' deficits also depends on the financial system development level, first af all because an undeveloped banking system discourages the national savings. Secondly, an undeveloped financial system could not efficiently assign capital inflows and savings towards investments. The third reason referes to a banking system crisis that would support an exchange rate crisis.

The real exchange rate and the exports and imports elasticity influence the exported and imported volume of goods, and therefore the external deficit's sustainability. The national currency

[64] That splits the private and public sector gap.

devaluation represents a major risk for the current accounts' sustainability, because it makes the external financing more expensive.

Other determinats also have impact on the current accounts' sustainability level are the economy's degree of openness, the structural reforms and the level of labour productivity..

An extremly important aspect that must be considered when studying the current accounts' deficit sustainability referes to determining an „anchor", like some comparing criteria. This kind of anchor for establishing the current accounts' sustainability could be avoiding insolvancy of a certain country, this representing one of the economic policy strategic goals.

The convergence criterias and the balance of payments

The euro area balance of payments represents a statistical overview of the economic operations between the resident and non-resident countries of the euro area, registred in a certain period of time, usually one year

The European Commission Treaty establishes that joining the third stage of EMU dependes on meeting the real and nominal convergence criterias and could be realised at the moment chosen by each country. Also the Treaty sets the *exclusion clause* , according to which Great Britain and Denmark can remain outside the EMU if they decide so, despite meeting the convergence criterias.

The convergence criterias (Maastricht criterias)[65] are variables that express the homogenity degree between the economies regarding the main features. Between the EU member states must exist a certain degree of homogenity so that the economic growth in the EMU could be sustainable, and so that the possible common shocks sholudn't determine asimetric effects between the member states.

The nominal convergence represents the medium term progress to reaching Maastricht's nominal convergence. The sustainability of meeting the nominal convergence criterias represents a sine qua non condition for joining the euro area

The nominal convergence criteria can be clasified into *monetary criterias* (the first three) and *fiscal criterias* (the next two) and they are:

- *price stability*: the average inflation rate of the countries wishing to adopt the euro must not overcome by more than 1.5% the average inflation rate of the first three most performant economies regarding the price stability;

- *interest rate.* The countries wishing to join the euro area must have a long term nominal interest rate that should not overcome by more than 2% the long term average interest rate of the first three member states with the lowest inflation. \

- at least two years before joining the euro area, tha candidate countries must join the ERM II, proving their **national currency stability** through maintaining it between + / - 15%compared to a central parity established copared to the euro[66].

ERM II represents a sort of training room, that allows the transition period needed for adopting the euro. Joining the ERM II is optional regarding the period of time chosen, but is mandatory for adopting the euro. MRS II represents a mechanism through which the EU assures that the member states are heading towards stability, from an economic point of view.

- *The budgetary deficit* must represent not more than 3% of real GDP;

[65] The maastricht criterias are included in the 121 Article of the Treaty and in the 21 Protocol atached to the Treaty.

[66] When establishing the central parity there must be considered the balance exchange rate and the exchange rate's evolutionin the period before determining the central parity, for being credible and for diminishing the risks. The central parity must reflect the economic reality.

- ***The external debt*** can not overcome more than 60% of GDP. There are some exceptions to this conditions, for countries with a decreasing external debt, that insures a close percentage to the established value.

Meeting all the criterias with the apropriate values does not involve the real convergence.

All the candidate states must also meet the **legal convergence** criterias. This means adjusting the national legislation and the regulations issued by the member states' Central Banks to be fully compatible to the ESCB Statute, in order to planning and implementing the European monetary policy. Largely, this convergence referes to problems regarding the national Central Banks independence and their integration in the ESCB.

In addition to the nominal convergence criterias, when assessing if a member state is ready or not to adopt the euro, the European Commission and the European Central Bank also consider the market integration, the balance of payments' situation, labour costs and other price indicators (real convergence).

The real convergence implies the economic development that insures reaching the EU's and euro area's real income level, the gradual proximity, as coherent and as faster as posible, regarding the income per capita and the price level, of those closest regarded from the economical development point of view. In other words, the real convergence involves equalizing the living standards, what the EU calls „economic and social cohesion". The variables that express the real convergence are: the unemployment rate, the structure of the balance of payments[67], national income per capita and public expenditure. For obtaining this it takes more time than for meeting the nominal convergence criterias, as their acomplishment affects positively the real variables.

After the research conducted for realizing this paper and in order to argument the theory, in the following part, we will try to analyse the main convergence indicators and also to draw up the most appropriate conclusions regarding our countries situation. .

As regarding our country's recent **price stability,** the inflation rate was above the reference value. In March 2010, the reference value was 1.0%[68]. În Romania, the inflation rate registred was 5.0%, 4.0% above the reference value.

After a period of deflation, HICP was below 4% in the second part of 2007 and 2008, on the account of raising food and fuel prices. In July 2008, the annual inflation rate reached the high value of 9.1% and remained that way despite the strong economic downturn, registering 5% in the second half of 2009. The gap between the euro area inflation rate reflects a rise in the price of tabaco, fuel and the persistent inflation in services sector. In the fiors quarter of 2010, the annual inflation rate still remained high, registering 4.6%.

The Romanian economy was strongly affected by the global economic downturn, as our country's economic growth decreased from 7% in 2006-2008 to -7.1% in 2009, on the account of the decrease of the local demand, and on the back of approved credits and investment inflows.The available information and indicators for the first semester of 2010 sugest a superficial recovery of the Romanian economy. The forecasted GDP growth is 0.8% for the year 2010 and 3.5% for 2011, reflecting so an increase of the local demand components, except the public expenditure.

The labour market reacted late at the difficulties of the economic situation. The unemployment rate increased to 6.8% in 2009, from 5.8% in 2008. In 2009 the labour productivity decreased to registering negative values, on the back of lower results.

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[67] Article 121 from the EU Treaty (1992) afirms that b esides the qualitativ criterias, „the state and evolution of current account balance" of al the candidate countries must be examined before they join the euro area\

[68] Calculated as the average of Portugal, Belgium and Estonia's last months' average inflation rate, plus 1.5%

Since 2005 Romania operates in an inflation targeting framework, combined with a floating exchange rate regime. BNR highlighted the fact that all exchange rate and monetary operation instruments will remain available, including the interventions for stabilizing the national currency.

The leu's exchange rate floated a lot in the 2000's. Between 2004 and 2007 the leu appreciated, on the account of capital inflows, attracted by the slight economic recovery and the EU accession perspectives. After a five years appreciation, in the second half of 2007, the national currency suddenly depreciated, as a consequence of the first signs of global financial markets downturn. The leu's depreciation trend in 2007, was only interrupted in the second part of 2008.

Another important moment of the leu's depreciation was in 2008, on the account of worsening of the global financial markets situation and the rising fears of foreign investors towards the macroeconomic imbalances. After Romania asked for international financial assistance, the financial market pressures lowered and the national currency stabilized for a while during 2009. Financial market pressures reappeared at the end of 2009, on the back of the local policy uncertainties. At the begining of 2010, the financial markets conditions improved and the leu's exchange rate registred a slight improvement.

In Romania, the long term interest rate was all the time above the reference value, since January 2007, when our country joined the EU. In March 2010, the reference value, as calculated by the average long term interest rate of Portugal and Belgium, plus 2%, was around 6%, and Romania's long term interest rate was 9.4%, 3.4% higher.

As regarding the external deficit, the Council adopted a decision, saying that Romania registred an **excessive deficit**, based on the previous year's deficit of 4% of GDP. In the same time, the Council recommended our country to correct the excessive deficit until 2011. In February 2009, the Council suggested new recommendations, that should be met until 2012. An increase on financial efforts was recommended and also strengthening the fiscal policy and adopting and implementing pesions reform.

The governmental deficit rose in the period 2005-2009, reaching 8.3% of GDP in the last year. The worsening of our country's defict between 2005 – 2008, when the real GDP growth registred 6.4%, was on the back of the expanding fiscal policy orientation, reflected by the structural deficit deterioration, that reached 7.7% of GDP, in 2008. The fiscal deficit deterioration is a sign of the economic downturn's effects on governmental financing

The approved budget for 2010, adopted in January 2010 expresses a 6.3% of GDP deficit. According to the political conditions reflected by the programme for supporting the balance of payments, tha planned adjustments are tied to expenses: the measures imply a 2.2% of GDP reduction, but also an increase in incomes of 0.5% of GDP. Anyway, the 2010 Commissions spring forecasts show a deficit of 8% of GDP.

Romania's external deficit reached 12.8% of GDP in 2007**,** followed by a slight reduction in 2008 to 11.1%. The strong increase of the external deficit between 2005 and 2007 reflected a deterioration of the trade balance, because the imports were encouraged by a strong internal demand. In 2008, Romania's external deficit started to adjust, as a result of the internal demand decrease and the consumers' preference for local products and also continued in 2009. As to regarding the services, the trading balance was neutral in the last period. The negative income balance decreased, on the back of decreasing the investment profit repatriation by foreign companies in 2007. In change, the repatriated income by the Romanian workers that work abroad represented a supporting factor of the external deficit, even though their contribution decreased in 2009, on the account of the global financial crisis.

As regarding the saving – investment balance, the rise of the external deficit between 2005 – 2007, was largely due to accelerating the local investment activities, while the savings rate followed a slight increase. The difference between savings and investments strongly decreased on the account of the economic downturn and the balance of payments adjustment in the financial and non-financial sectors.

In the last yerars, Romania's deficit was largely covered by FDI net inflows (on the back of the privatization process). In 2007, the FDI percentage in financing the external deficit decreased to 45

The financial accounts surplus decreased to 5.3% of GDP in 2009, from 12.6% in 2008. The decrease can be explained by the decrease registerd by other investments as well, although the international financial assisstence acted like an offset. The FDI net inflows decreased considerably under 4% of GDP in 2009, reflecting the reinvested profits.

The international reserves rose by 1% of GDP in 2009, partially due to the IMF loan.

Romania's **external debt** rose rapidely in the last years, reaching 68% of GDP in 2009. Before the economic crisis, the balance of payments positions' worsening was largely due to the loans from the banking sector. In 2010, the strong need for credit will probably contribute to our country's external deficit.

Conclusions

The main conclusion that can be drawn after this research is that the balance of payments represents an un replaceble instrument to describe a country in its relations with the international environment, for assessing the strenghts and weakneses in its international relations. Also, the balance of payments explines a lot of things about every country's economic structure, about its past and future.

As regarding Romania, the European Commission considers that our country does not meet any of the euro area accession criterias, like the price stability, the governments budgetary position, the exchange rate stability and the long term interest rate convergence, but it also faces law-making obstacles.

As regarding the convergence criterias, our country's annual inflation rate is above the reference value since we joined the EU..

Romania does not meet the budgetary position criteria, being submitted to an excessive deficit procedure and having to reduce the negative balance of public expenses to under 3% of GDP until 2012.

For joining the euro area, a country's national currency must be included in ERM II. The leu's exchange rate is still free, and the downturns on the global financial markets, starting with the the second half of 2007 determined an appreciation, also supported by our country's macroeconomic imbalances.

Long term interest rates were still very high in 2009, on the account of the market volatility, before decreasing at the beginning of 2010, as a result of the internal market indicators improvement.

The external deficit reached 12%of GDP between 2007 and 2008, on the back of the accelerated growth of internal demand, and after it decreased, being supported by the trade deficit reduction..

As a result of the legal compatibility and meeting the convergence criteria, the European Commission considers that Romania does not require the conditions for adopting the European currency.

Anexa 1

ROMANIA'S BALANCE OF PAYMENTS							
		2004	2005	2006	2007	2008	2009
Current Account		*-8.4*	*-8.6*	*-10.5*	*-13.4*	*-11.6*	*-4.5*
	Goods balance	-8.7	-9.8	-12.1	-14.3	-13.6	-5.9
	Services balance	-0.3	-0.4	0.0	0.3	0.5	-0.3
	Income balance	-4.2	-2.9	-3.3	-3.3	-2.7	-1.8
	Current transfers balance	4.9	4.5	5.0	3.9	4.3	3.5
Capital Account		*0.8*	*0.7*	*0.0*	*0.7*	*0.4*	*0.5*
External deficit[69]		-7.5	-7.9	-10.5	-12.8	-11.1	-4.0
Financial Account		*6.1*	*7.5*	*9.6*	*13.5*	*12.6*	*5.2*
	FDI	8.4	6.6	8.9	5.7	6.7	3.8
	Portfolio investments	-0.7	1.0	-0.2	0.4	-0.4	0.4
	Other capital investments	6.3	6.6	6.3	11.0	6.3	2.0
	International financial assistence						7.7
	Official reserves	-7.9	-6.7	-5.4	-3.6	0.1	-1.1
Financial account without official reserves		14.0	14.2	15.0	17.0	12.6	6.2
Errors and omissions		*1.4*	*0.4*	*0.9*	*-0.7*	*-1.5*	*-1.2*
Gross capital formation		23.7	23.3	26.5	31.0	31.3	25.1
Gross savings		17.9	14.4	15.9	17.3	18.6	20.8
External debt		35.2	38.7	42.1	47.0	51,8	67.9
International investment position		-26.9	-29.0	-37.7	-43.5	-49.4	-61.1

Source:information published by Eurostat and BNR, in the Convergence Report 2010

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