EURO – CHALLENGES AND PERSPECTIVES FOR ROMANIA

Sandu Carmen
„Al. I. Cuza" University of Iaşi
Faculty of Economics and Business Administration

The process of preparation and adoption of the European single currency is one of the most important challenges that Romania has to face in the first decade as a full time member of the European Union. This process will test both the political and the administrative capacity, requiring very clear programs for the adaptation of European regulations and directives that will ensure real and nominal convergence. This process will surely prove to be a difficult one and it will bring a high degree of pressure upon the economic system in general. The worldwide financial crisis is making the process of single European currency adoption even more difficult for Romania. Although its effects are not directly felt in Romania, the disorder created within international markets can easily transform the management of economic and currency politics into an insecure and extremely difficult task.

Keywords: exchange rate, euro, Economic and Monetary Union, Euro Zone, convergence criteria, ERM II, NBR, ECB, financial crisis

Cod JEL: F15, F36

1. Introduction

More than 10 years ago, in May 1998, EU leaders took a historic decision, to secure an irrevocable economic integration in the Community: introduction, starting with the 1st of January, 1999, of the European single currency - euro. Today, the euro is the currency used daily by over 300 million citizens in 15 countries constituting the euro area (Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovenia, Spain) and enrolled in a fierce competition with the U.S. dollar to gain supremacy in international financial markets.

The accession to the euro area will represent a second step of great importance for Romania, after the accession in the EU at January 1st 2007. The period 2007-2014 (2015) 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 analysis with the following restrictions: the fulfillment on sustainable bases of the Maastricht criteria, the accomplishment of a satisfactory level of real convergence and reducing the participation in ERM II at the compulsory period of two years.

The benefit of a country's accession to a monetary union is the enhancement of foreign trade, which then leads to a faster economic growth. Equally noteworthy are the positive effects resulting from an increased financial discipline, the significantly improved acces to the capital and the stability offered by the capital market forming at a union level.

The crisis affecting at this moment the international financial system introduces an additional factor of uncertainty and if prolonged, it may complicate the process of adopting the euro in Romania. On one hand, the management of the real and nominal convergence process becomes more difficult; on the other hand, the current crisis may prove to be the most serious test for the European financial system and its currency, the euro.

In the following I intend to summarize and make some comments on the issues major process-related training to adopt the euro, on the timing of implementation and impact of the euro on the Romanian economy.

2. The strategy of transition to the single European currency

It is my opinion that before engaging in any discussion on the future adoption euro by our country, a strategy should be elaborated in order to identify the requirements for the Romanian economy to fully benefit from the adoption euro, the succession of measures to be taken in ensuring the fulfilment of these requirements and their implementation calendar.

The measures ensuring the fulfilment of nominal convergence criteria (Maastricht criteria) will be thoroughly examined and the adequate economic policies for the transition period through ERM2 will be established. The analysis of other countries' experience in passing through the process of adopting the euro currency or which are about to do so would be particularly useful to us, keeping however in mind the unique situation of each country.

After the adhesion to the European Union, the next strategic target for the Romanian authorities concerning the macroeconomic domain is related to the adoption of the euro currency. Estimated for the 1st of January 2015, the Euro Zone entry implies meeting some performance requirements concerning the macroeconomic indicators (nominal convergence stipulated in the Treaty of Maastricht). Although in order to fulfil nominal convergence it is necessary to observe 5 criteria, the macroeconomic theory shows that a consolidation of the disinflationary process would result in a high sustainability of the macroeconomic equilibrium, especially in Romania's case, where observing the convergence criteria concerning inflation rate and budget deficit remains one of the delicate problems at the economic level.

Table no.1: The Maastricht criteria at the level of Romania
(Nominal convergence indicators)

Nominal convergence indicators	*Maastricht criteria*	*Romania 2009*
Inflation rate (percent, annual average)	<1.5 pp above the average of the most performant 3 EU members	5,6
Consolidated budget deficit (percent of GDP)	below 3%	7,9
Debt (percent of GDP)	below 60%	21,0
Exchange rate (RON/EUR) (maximum procentual appreciation/depreciation compared to the average over 2 years)	+/- 15%	+1,6/-18,2
Long-term interest rates (percent per year)	<2 pp above the average of the most performant 3 EU members	9,7

Source: Eurostat, BNR (National Bank of Romania)

One of the superior forms of European integration and at the same time the most ambitious and risky project of European construction is the Economic and Monetary Union. Accordingly, any state adhering to the European Union intends to take part in this project sooner or later. On January 1st 2007, Romania and Bulgaria, the last two members adhering to the European Union, set themselves the same objective. When becoming an EMU member, Romania will replace the national currency – leu with the european single currency; but until reaching this advanced stage, it will have to meet all the criteria required by the adhesion to the Eurozone.

Adopting the euro implies participating to the Exchange Rate Mechanism II for at least two years, during which the national currency would have to show a high degree of stability as opposed to the euro. In establishing a coherent calendar for the adoption of the single currency, two fundamental decisions must be taken concerning the entry moment to ERM II and the duration of participation to this mechanism.

The European Central Bank recommends that acceding to ERM II mechanism should take place after the adhesion of the concerned countries to the European Union and that the duration of participation should not exceed the compulsory period of 2 years, which means that the country is to have a consolidated macroeconomic stability at the moment of accession. Furthermore, it is essential to sustainably fulfil the nominal convergence criteria.

As far as Romania is concerned, adopting the euro currency implies three stages. During the first stage – which precedes the entry to ERM II mechanism – it is necessary to consolidate disinflation, develop domestic financial market on a long term and achieve convergence of interest rates, to relatively stabilize leu exchange rate close to the long term equilibrium level and especially to deepen structural reforms.

The second stage – entering the ERM II mechanism – is estimated by BNR to take place in 2013. The moment has been chosen considering the need of fulfilling the nominal convergence criteria simultaneously with achieving significant progress in the real convergence process (convergence of GDP /inhabitant to purchasing power parity, convergence of income, productivity and socio-educational standards etc).

The last stage – Euro Zone entry – will take place around 2015. From that moment, Romania will take part in the coordination mechanisms of Euro Zone economic policies, having to observe the stipulations in the Stability and Growth Pact (mainly concerning public finance). Then, Romania will also adopt the common monetary policy of the European Central Bank, it will have to possess mechanisms of automatic economic balance (the flexibility of prices and salaries, a high degree of financial intermediation, business cycle synchronisation, labour market flexibility, perfect capital mobilization etc) and to increase the speed of fiscal policy reaction in order to absorb the symmetrical/asymmetrical shocks that domestic economy will have to face.

Adopting the euro currency in 2015 should represent one of the strategic objectives for Romania. Observing the stipulations in the Convergence Programme concerning the Euro Zone entry would represent a possible "reconciliation" between achieving nominal and real convergence[494]. However, adopting the euro would become a more and more unlikely objective, unless Romania proceeds to a consolidation of the disinflationary process, an increase in Romanian export competitiveness, predictability and performance of fiscal policy on a medium term, a higher absorption of European funding and a consolidation of structural reforms.

There are certain factors that could optimize the Euro Zone entry. Meeting nominal convergence criteria plays an important part, but those factors which facilitate a solid performance in the Monetary Union are even more important. They include flexibility in product/service markets and markets of factors of production, consolidation of pension system and social security reforms and a fiscal policy focused on the mobility of factors of production under unique market conditions, including labour force migration.

In order to fulfil the criteria of real and nominal convergence it is necessary to continue making efforts in:

- consolidating a decreased inflation;
- forming long term domestic capital markets and achieving convergence of interest rates with those stipulated by the Treaty. On the grounds of capital

[494] The Maastricht Treaty does not mention explicit criteria for real convergence, which involves reducing disparities between the countries on the price level and productivity, involving increase revenue in developing countries rising to the existing level in developed countries.

account liberalization and of emergence of private pension funds, it is necessary to develop government bond market;

- achieving a relative stability of the leu exchange rate on the market. A higher degree of exchange rate stability can be reached by increasing credibility of the convergence process and by stabilizing prognosis regarding long term exchange rate.

In 2008, worldwide economy entered the most severe crisis since the Great Depression of the 1930's. The high degree of synchronization of the crisis affecting both developed and emergent countries proved the extent of interdependency between world economies. Beginning with the last trimester of 2008, the financial crisis spread quickly in Romania as well, in the context of a world economy evermore globalized and more precisely, in the context of a Romanian economy strongly related to the European one, making any negative external shock spread rapidly at an internal level.

During the first nine months of 2009, the evolution of the real economy was severely damaged by the economic and financial crisis, given the fact that we are a relatively small economy with a high degree of openness. Consequently, while in the IVth trimester of 2008, GDP increased by only 2,9% since the same period in 2007, during the Ist trimester of 2009, gross domestic product – in real terms, gross series – decreased by 6,2% from the Ist trimester of 2008, and this tendency continued to increase in trimesters II and III when the economy contracted 8,7% and 7,1% respectively.

Comparing with other EU member countries, analysts estimate Euro Zone entry date to 2015 for Romania and Bulgaria, 2013 for Lithuania and Poland and 2014 for the Czech Republic and Hungary. However, the estimates for these countries are not definite, since the adoption of euro could be either advanced or delayed. Euro Zone countries would want to be certain that they will not let "another Greece" join the club. According to analysts, only Estonia is likely to adhere to the Euro Zone in 2011. All the possible delays for the countries aspiring to the Euro area entry are caused by the financial turbulence in Greece.

With the opportunity of entering the Euro zone after over a decade of getting used to the single currency, ten European Union member states, including Romania, will have much to learn from the experience up to this point. But for this, economic reform measures will have to be taken early in order to ensure the achievement of a long term level of sustainable real convergence without which the path towards the euro could turn into a relatively bumpy road.

While some neighboring countries wish to rapidly benefit from the euro, National Bank of Romania representatives state that we would be unable to precipitate the adoption of the single currency. Some banking specialists claim that the transition to the euro would bring us more benefits than losses. For example, we would pay much smaller interests for loans and significantly smaller commissions on money transfers operated through banks. Many analysts think that the adhesion to the Eurozone should be accelerated. The real economy has "de facto" adopted the single currency up to 80%, given the fact that prices for many products and services are listed in euro and over half of the bank loans are in foreign currency and the corresponding interests are up to three times smaller than those in leu. A Deutsche Bank report also indicates that for some Eastern Europe countries, a more rapid euro adoption would mean certain advantages, given the actual problems of financial stability, thus eliminating the exchange rate risk. At the same time, both the government and the population would gain access to cheaper loans from a more liquid market.

3. Effects of euro adoption

In the first decade following the introduction of the single currency, the Eurozone enjoyed a significant decrease in inflation and long term interest rates but also an increase in employment and consequently a substantial correction of budgetary imbalances. At the same time, however, economy registered growth levels comparable to the decade preceding euro adoption, gross

domestic product per capita in the Eurozone still reaching only 70% of the one registered in the United States. The introduction of the single currency is obviously not the only one accountable for these facts which are also the consequence of a wide range of internal factors (community policies, including those introduced by the Economic Stability and Growth Pact, Lisbon Strategy but also individual policies and developments of member state economies) and external factors (deepened economic globalization, accentuated financial market integration).

Some positive effects of the introduction of the single currency which are undoubtedly found at several levels are particularly noteworthy and worth analyzing.

Firstly, the introduction of euro played a particularly important part in insuring macroeconomic stability. Founded with the primary objective of maintaining price stability in the Euro zone (defined through maintaining inflation rate under but close 2% on a medium term), the European Central Bank firmly implemented the single monetary policy leading to a consolidation of euro's credibility, to a long term price anchoring and to creating premises for sustainable economic growth.

Concurrently, introducing the single currency encouraged a decrease in financing costs both for private and governmental economic actors in the states that adopted it. Last but not least, euro improved Eurozone endurance to international financial turbulence, such as, for example, the "dot-com" crisis, the problems following 9/11 terrorist attacks and, more recently, in the context of the actual international financial crisis.

Secondly, euro contributed to intensifying economic and financial integration in the Euro zone. Commercial trade between Eurozone states now forms a third of the GDP corresponding to the Euro zone, against a quarter ten years ago, mostly due to the elimination of exchange rate volatility.

Moreover, foreign direct investment between participating states now reach a third of the Euro zone GDP, against approximately 20% ten years ago, up to two thirds of this increase being directly put on the account of the introduction of the single currency. These developments have, in turn, attracted many positive effects such as intensified competition and efficiency. As far as financial markets are concerned, the adoption of euro lead to a full integration of interbank money markets, as well as a deeper integration in securities market (mainly stocks and bonds). However, retail financial markets still remain fragmented mainly because of legislative and linguistic barriers.

Thirdly, the single European currency strengthened European identity worldwide. The euro became the second international currency and is used in 37% of the international currency exchange, constituting approximately one quarter of the international reserves, according to available statistics (many Asian countries do not publish their data on currency reserves). Keeping in mind the prospective broadening of the Eurozone through the adoption of the single currency by other ten states in the European Union, in the following years, euro will become the currency of the widest economic space in the world. But beyond its tangible effects, euro has become a symbol of united Europe with more than half of Eurozone citizens associating the European Union to the euro.

The risks generated by the introduction of the single currency in Romania are relatively few but they have a direct impact on everyday life and on the financial system. The most popular risk is related to the generalized price increase which would be due to the population's lack of familiarity with the new prices shown in the single currency and to the speculations regarding approximation errors.

Another risk related to the transition of the Romanian economy to the euro, as it is for all countries which make this step towards integration in the Eurozone, is establishing the proper quantities of short term liquidities in euro at the banking system level, considering a demand in cash of the single currency.

Another disadvantage deriving from the participation to the Monetary Union is losing the possibility to choose inflation rate and losing exchange rate as an instrument in eliminating macroeconomic imbalances.
At the same time, it should be mentioned that changing the national currency in favor of the single currency would mean losing control and power of decision concerning monetary problems and flexibility in taking decisions which would protect Romanian economy from external shocks.
Finally, considering both the benefits and the risks regarding the transition of the Romanian economy to the single European currency, we can undoubtedly assert that the direction towards integrating the European Economic and Monetary Union, chosen by the Romanian political class is the right one and that on a medium and long term, this will contribute to obtaining certain advantages for the entire Romanian society.

4. Conclusions

Maintaining the credibility of the single european currency is a particularly complex process with a continuous development, which needs much more than a good functioning of monetary mechanisms inside the Eurozone.
It is not accidentally that the three phase integration process aims at constituting the "Economic and Monetary Union". The two components are mutually conditioned: the effective implementation of economic policies and obtaining sustainable economic growth essentially depend on euro stability and credibility; to the same extent, maintaining inflation in the Euro area at a minimum level is conditioned by the existence of a coherent mix of economic policies which would facilitate reaching ECB primary objective. This last correlation is all the more difficult to optimize in practice as ECB single monetary policy coexists with fiscal, income and decentralized structural policies of the member states.
The current international financial crisis could also have negative effects upon the exchange rate, which is significant in terms of the convergence criteria, to have access to the Euro area. And from this perspective, the Romanian authorities consider the exchange rate to be essential in adopting the single currency. However, some analysts on financial markets have calculated that the rate could record huge fluctuations that might come into conflict with applications for convergence to the Euro area.

References:

1. Arrestis, Philip, Brown Andrew, Malcolm, Sawyer, The euro. Evolution and prospects, Ed Edward Elgard, Cheltenman, UK, Northampton, MA, USA, 2001
2. Bran, Paul - Currency International Financial Relations, Economic Publishing House, Bucharest, 1995
3. Chris Mulhearn, Howard R. Vane - The Euro: Its Origins, Development and Prospects, Edward Elgar Publishing, 2008
4. Copeland, Laurence S. - Exchange Rates and International Finance, Pearson Education, Great Britain, Fourth Edition, 2004
5. Papazoglou C, Pentecost, E.J. - Exchange Rate policies, prices and supply-side respond, Palgrave, Great Britain, 2001
6. Peter B. Kenen, Ellen E. Meade - Regional Monetary Integration, Cambridge University Press, 2008
7.Voinea, M. Gheorghe - International Financial-Currency Relations, University Publishing House "Al. I. Cuza, Iasi, 2007
8. www.bnr.ro
9. www.insse.ro
10.www.ecb.int