

ANALYSIS FOR THE DEGREE OF EUROIZATION IN ROMANIA

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Euroization is defined as the adoption of the Euro currency by the authorities from a country outside the Euro area, as a legal currency and as an official currency, and this means that the country chooses to give up its national currency and that the national bank gives up using the monetary policy as an instrument of the economic policy. The objective of this study is to adjust the extent of meanings of the Euroization concept for Romania and to explain it under the terms of the optimum currency areas theory. Thus, an economy characterized by a high Euroization will be more ready to give up its national currency in the future, as that economy has passed the test of using the currency it wants to adopt. This study makes an analysis for the causes of Euroization, based on the economic literature and we have examined the forms of occurrence of Euroization in the Romanian economy, insisting upon the aspects related to the preferences of the economic agents for crediting and saving in the Euro currency. We consider that the increase of the Euroization degree may be considered an opportunity for the economies which propose to adopt the unique European currency, meanwhile constituting a vulnerability if adopting the unique currency is delayed and if that economy is affected by the external shocks which induce a depreciation of the national currency. The partial Euroization of the Romanian economy has encouraged the overheating of the national economy until 2008, but it fractured the adjustment capacity of the shocks by means of the monetary policy and of the rate of exchange. Thus, a partial Euroization acquired a characteristic of a unilateral Euroization, in which the capacity of the economy to neutralize the shocks gets decreased and the dependence on the decisions of the Central European Bank, respectively of the economic agents from the highly commercially and financially integrated countries with Romania gets increased.

Keywords: euroization; Euro area; financial integration

JEL codes: F15, F36

I. Introduction

Euroization is defined as the adoption of the Euro currency by the authorities from a country outside the Euro area, as a legal currency and as an official currency, and this means that the country chooses to give up its national currency and that the national bank gives up using the monetary policy as an instrument of the economic policy. Euroization supposes to give up its own currency and to adopt the Euro currency, before meeting the nominal convergence criteria. Actually, Euroization may be under several forms. One of them is that of setting up a monetary council according to the Euro currency, and this reduces the stabilization role of its own monetary policy. Another one refers to the unilateral Euroization decision, by accepting the Euro as currency, such as Kosovo, Montenegro and Monaco. The last form is the least met and it refers to the decision of the economic agents to achieve bank, trade operations in the Euro currency or to express certain priced in the unique European currency. The first section of this study makes an analysis for the theoretical meaning of this concept and the costs, respectively the benefits

associated to this decision, and the second part of the study makes a research of the degree of Euroization in the Romanian economy.

II. Causes of Euroization

Euroization is determined by certain European economies' desire to consolidate the trade relationships with the Euro area member countries, and also the need to import monetary stability and low inflation. Among the causes of Euroization, mentioned in the economic literature, we may also find: macroeconomic instability, the monetary policy regime adopted, the foreign exchange risk, and also the instability of the institutional and regulating environment. Another cause of Euroization is a volatile and unpredictable inflation, as well as the economic and political uncertainty cases. The countries with a higher Euroization are quite small countries, geographically located near Euro area countries, with political and trade relations with them. Unilateral Euroization protects the countries against the foreign exchange crises, but it cannot prevent other types of crises. For example, an unsustainable public debt or the worsening of the foreign unbalances may determine the international investors to withdraw their investments. Buitier and Graf (2002) consider that the unilateral Euroization allows a good entrance in the Euro area, thus avoiding foreign exchange crises. Nevertheless, the unilateral Euroization cannot be considered as a substitute of the economic and monetary integration: it does not allow nominal adjustments during the convergence period and it prevents the market from assessing the sustainability of the exchange rate.

The unilateral Euroization contributed, in some of the countries, such as Kosovo and Montenegro, to a quick macroeconomic stabilization after an economic and political crisis. Nevertheless, Euroization involves long-term risks of financial instability associated to the loss of the function of lender of last resort, especially in the countries characterized by a low number of banks with foreign capital and with a fragile external position. Kosovo and Montenegro used the German mark as their currency and they unilaterally adopted the Euro currency, although they do not have an explicit agreement with the European Union which could allow it to them. Euroization is not a quick solution for the structural problems or for the stability policies. The economic benefits cannot be obtained if they are not supported by solid economic policies and by continuous reforms. These aspects suggest the fact that a high prudence is necessary in assessing the proper characteristic of the unilateral Euroization.

The most important costs involved by Euroization refer to the following:

1. **The loss of an adjustment mechanism for the economic shocks.** Euroization involves the loss of the monetary policy independence and the impossibility to use its instruments to correct the asymmetric shocks and to react in order to synchronize the business cycles with those of the Euro area. Euroization increases the uncertainty referring to the effects of the monetary policy. Due to the high degree of Euroization, the interest rate is an instrument with low efficiency in fighting against inflation. The Euroized economy should rely on other adjustment mechanisms in order to avoid the output gaps due to the asymmetric shocks or to the business cycles' non-synchronization with that of the Euro area.
2. **The loss of the function of lender of last resort.** The Euroization determines the loss of power of the domestic authorities in reacting to the pressures related to converting the credits into assets. Due to Euroization, the central bank can no longer intervene to provide emergency financing to the financial institutions facing short-term liquidity blockages. Under the terms of the total Euroization, the central bank has no longer the possibility to issue currency, and the last resorts lose their financing source. Thus, in order to avoid the liquidity crises, Euroization should be accompanied by providing alternative financing sources to the last resorts.

The most important benefits generated by Euroization refer to the following:

- **Macroeconomic stability and lowering the rate of inflation.** Euroization encourages the macroeconomic stability by solving the credibility problems occurring when a central bank is not able to provide a low rate of inflation. Moreover, Euroization increases the financial discipline by eliminating the possibility to issue currency in order to finance the budget deficits. By implementing the monetary policy by the European Central Bank, which provides a higher credibility degree, the rate of inflation and the rates of interest in the Euroized economy are expected to be decreased towards the levels recorded in the Euro area countries. These benefits are much higher, especially for the countries which faced financial instability and where the monetary policy measures implemented did not decrease inflation.
- **Decreasing the risk premiums.** If they are determined by the evolutions of the rate of exchange and not by the country risk, then the Euroization should result in their decrease, because a sudden and massive depreciation of the rate of exchange will no longer occur. At the same time, Euroization could generate an improvement of the access to the markets with a low foreign exchange risk, with a more stable financial sector, respectively with a lower risk of sudden infusions of capital. Eliminating the foreign exchange risk and the eventual depreciation of the national currency, as well as the price stability, the unilateral Euroization allows a decrease of the rates of interest, of the financing costs and of the public debt (Schoors, 2002; Levasseur, 2004).
- **Development of the domestic financial sector.** Euroization is accompanied by a development in the financial sector, as a stable currency is a prerequisite for the financial development, resulting in a higher and more sustainable economic growth. The main benefits of Euroization are the decrease of the transaction costs, of the costs with information, of the foreign exchange risk premiums, stimulating investments and trade and macroeconomic stability. Eliminating the costs with the foreign currency exchanges is one of the major benefits of Euroization, saving costs proportionally with the number of transactions made in the foreign currency.
- **Economic and financial integration.** Euroization encourages the financial integration of that economy with those of the Euro area countries. Euroization encourages the trade integration, due to the elimination of the transaction costs and, as a consequence, the intensification of the trade with the Euro area member countries. Lower foreign exchange reserves are needed, as a margin of maneuver is no longer necessary by means of interventions to protect the rate of exchange, and to cover the imports, considering that most of them are denominated in the Euro currency.
- **Higher synchronization with the business cycle of the Euro area.** As a consequence of a higher economic integration, Euroization results in the increase of the degree of real convergence of the business cycles with those of the Euro area countries. Finally, the shocks will become more symmetrical between the Euroized country and the Euro area, while the business cycles will become more synchronized.

III. Occurrence forms of Euroization in Romania

Doing a short exercise, we may assume that Romania could decide to suddenly adopt the Euro currency, giving up its national currency. The significant advantage of such a strategy is the decrease of inflation at the level of the Euro area, without unemployment costs. Inflation in Romania would be equal to that of the Euro area, and the economic agents know this and, consequently, they correspondingly delineate their inflation expectancies. Thus, Romania benefits from the ECB credibility import, thus being able to obtain welfare benefits generated by the monetary union. Such a sudden strategy would not need the decrease of inflation before joining the monetary union. Even though the Euroization phenomenon in Romania is a partial and not total one, such as in the previous section, it may be explained according to the previously presented costs-benefits balance.

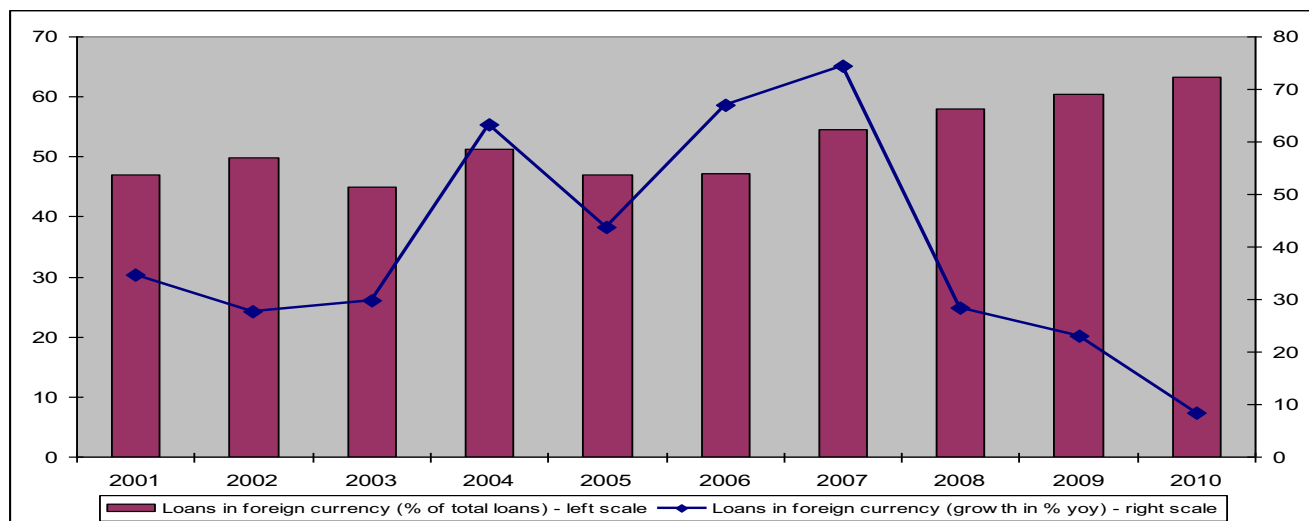
Euroization followed a Dollarization trend occurred when the transition started, and it constituted a refuge of the private economic agents and also of the state, under the terms of a difficult macroeconomic stabilization, which also reflected in the persistence of a quite high rate of inflation in the national economy. This phenomenon occurred together with Romania's commercial and financial integration with the economic agents from the European Union, being amplified by the trend of appreciation of the national currency during the economic boom period. Under these terms, there were positive effects of wealth and balance upon the domestic economic agents, which induced a trend of taking loans/making deposits in the foreign currency and also the acceleration of consumption during the economic expansion period. Nevertheless, the Euroization of the Romanian economy has determined certain risks, which occurred more pregnantly along with the economic and financial crisis. Thus, the efficiency of the monetary policy in stabilizing the economy decreased, as the mechanism for transmitting the rate of interest controlled by NBR has been fractured. Moreover, the depreciation of the national currency has negatively influenced the payment capacity of the lenders in foreign currency, this resulting in the increase of the financial risk in the banking system. As a consequence, the partial Euroization of the Romanian economy encouraged overheating the national economy until 2008, but it fractured the adjustment capacity of the shocks by means of the monetary policy and of the rate of exchange. Thus, a partial Euroization acquired the characteristic of a unilateral one, in which the economy's capacity to neutralize the shocks gets decreased and the dependence on the decisions made by the European Central Bank, respectively by the economic agents from the highly commercially and financially integrated countries with Romania gets increased.

This section includes a few forms of occurrence of Euroization in Romania, which are specific to the financial substitution of the national currency with the unique European currency – the tendency to give loans in foreign currency, to make deposits in the same currency and to emphasize the role of the banks from the Euro area within the national banking system.

IV. Loans in foreign currency

The loans in foreign currency have been determined, among others, by the stability of the macroeconomic environment, by the relative level of the rate of interest in the foreign currency and by the trend of appreciation of the national currency during the economic expansion period. The percentage of the loans in the foreign currency of the total loans given was quite stable during the period 2001-2005, despite of a level of 51.3% in 2004. In 2007, NBR relaxed the conditions for the loans in foreign currency, so that the volume of the loans increased by 71% if compared to the previous year, and the loan in foreign currency increased by 76%, and the loan in lei increased by 68%. Out of the total loans, 45% were in the national currency, and 47% in the Euro currency. In 2009 the rhythm of increase of the total loans was of 13%, and the rhythm of increase of the loans in foreign currency was of 23%. In 2010, the rhythm of increase of the loans in the Euro currency was of 5%, and the loans in lei remained at the same level as in the previous year, the percentage of the loans in the Euro currency exceeding 70% of the volume of the total loans (according to the chart below).

The loans contraction was due both to the low offer of the banks (aversion towards the risk), and also to the low demand caused by the unfavourable economic conditions: the increase of the rate of unemployment, the decrease of the available revenues, the depreciation of the Euro currency, and the high costs of the creditors.

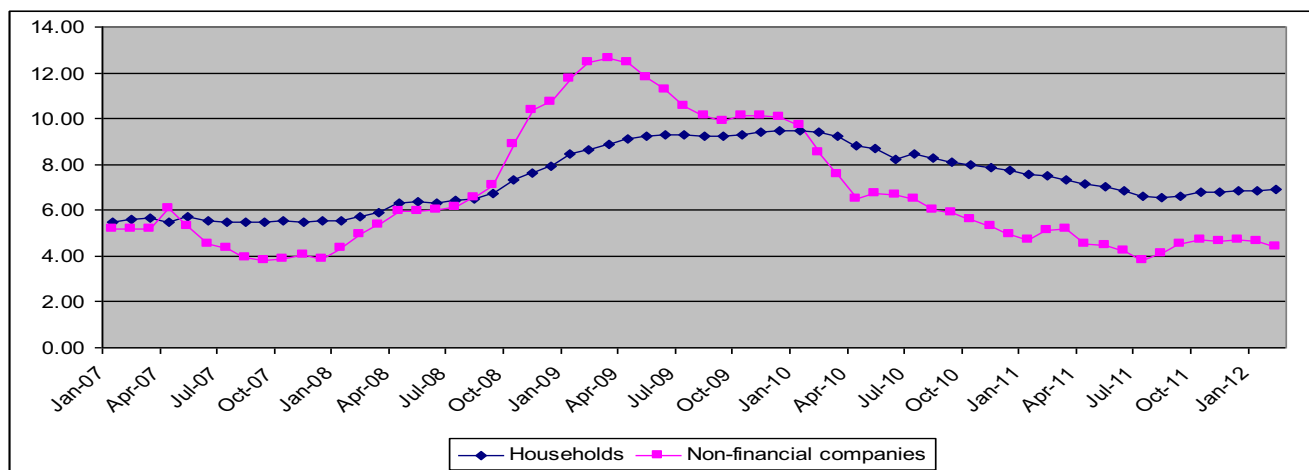


Source: CEE Banking Sector Reports 2006; 2009; 2011

Figure 1. Evolution of the loans in foreign currency in Romania

The increase of the loans in the Euro currency may be considered a cause of the natural catching-up process, generating the increase of the share of loans in the foreign currency given to the private sector in the GDP, so as to approach the levels recorded in the more advanced countries. Nevertheless, the increasing rhythm of the loans in the Euro currency should have been sustainable, as this increase, by supplying the internal demand, contributed to deepening the current account deficit and the increase of financial risk in the banking system. The share of the loans in foreign currency from the balances of the national banks was of 62.9 percents at the end of June 2011, on the background of recording a significant foreign currency position for the population. The loans in foreign currency became more risky if compared to those given in lei, from the point of view of the loan risk: (i) the non-performance rate for all the categories of loans in foreign currency given to population is superior or is close to that related to the loans in lei, and (ii) the dynamics of non-efficient loans in foreign currency given to companies is more emphasized than in the case of the segment in lei (recording an increase of 185 percents for the foreign currency, in comparison with approximately 91 percents for lei during the period December 2009 – June 2011).

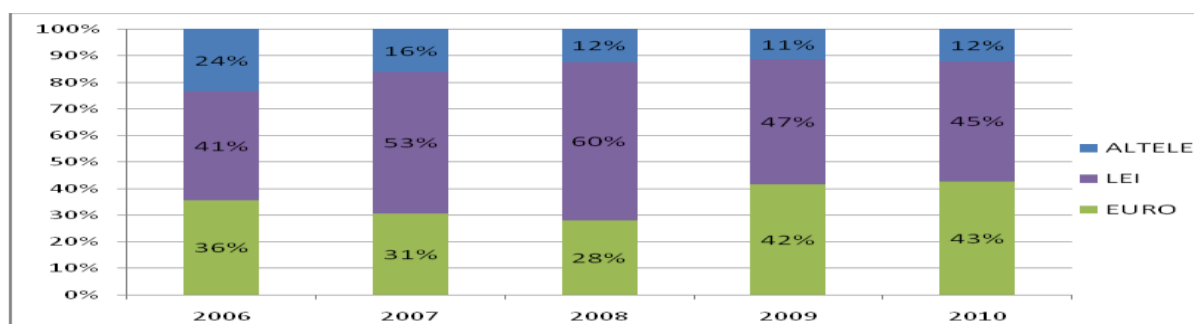
The access to loans in foreign currency has been facilitated by the quite low level of the rate of interest for this type of credits. Moreover, during the economic expansion period, the rate of interest in the national currency was increased in order to stop the economy's overheating phenomenon, and this determined the increase of attractiveness of the loans in foreign currency. After the crises has started, the national bank kept the high level of the interests in order to keep the stability of the rate of exchange and to brake the increase of inflation, not to stimulate the loans in foreign currency. The chart below presents the difference between the rates of interest of the loans in lei and for those in foreign currency for households and for companies, in order to explain the higher inclination towards loans in foreign currency.



Source: NBR, 2012

Figure 2. Differences between the rates of interests for loans (lei vs. Euro) (%)

Another factor stimulating the loans in foreign currency was the appreciation tendency of the national currency during the period 2004-2008. The economic and financial crisis emphasized the vulnerabilities of the Romanian economy, thus reducing the financial flows towards the Romanian economy and contributing to the depreciation of the national currency. This phenomenon does not generate the increase of the private debt only, expressed in the national currency but also of the rate of non-efficient loans, and also of the public debt, under the terms in which 55% represent the public debt expressed in foreign currency and, out of it, 43 percents represent the debt accumulated subsequently to the loans in the unique European currency. According to the chart below, we can notice that the doubling of the public debt starting from 2009 supposed the significant increase of the loans in the unique European currency.



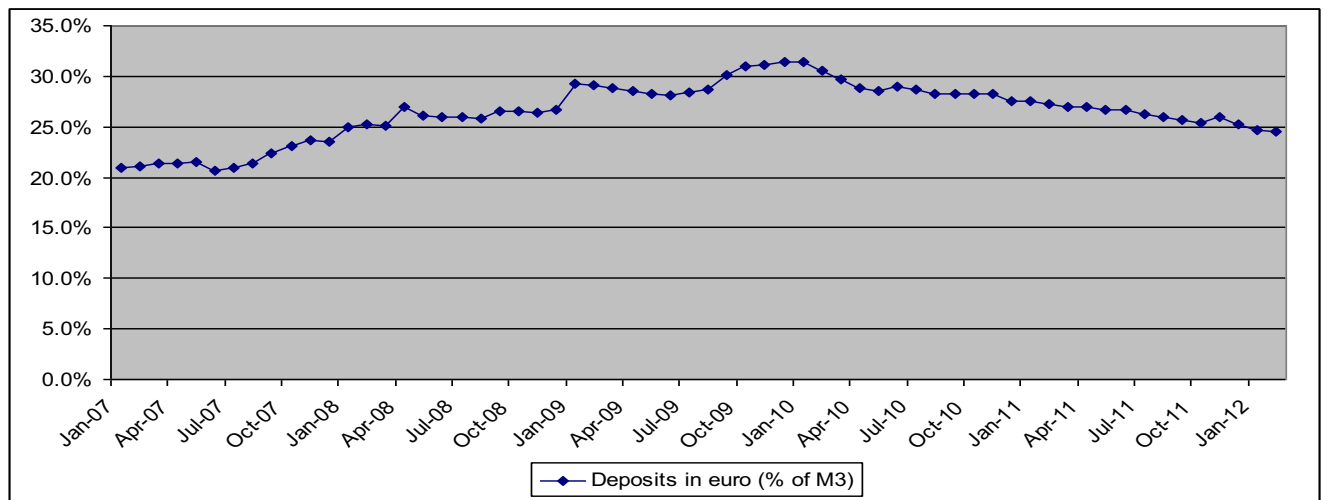
Source: Ministry of Finance – Public debt report 2011

Figure 3. Foreign exchange structure of the public debt

V. Deposits in foreign currency

The preference for Euroization of the deponents depends on their confidence in the national currency. In an economy with a high inflation which puts depreciation pressure the national currency, the population will choose to save in a stable currency. During the last 10 years, the population's confidence in the national currency as a saving modality increased very little, the share of the deposits in lei increasing from 60% in 2000 to 61% in 2010. The economic crisis affected the volume of the deposits in foreign currency, of which annual increasing rhythm decreased from 57% in 2008 to 5% in 2010, due to the lack of liquidity in economy under the terms of the financial crisis. In 2009, the banks constrained their loan activity and drawn their attention towards the activity of attracted deposits. As a consequence of the new strategy, the ratio between the loans given to the customers and the deposits attracted by it decreased from 122.0% at the end of 2008 to 112.8% in December 2009. In order to assess the importance of

Euroization in the deponents' preferences, we have calculated the degree of Euroization as a ratio between the total of the deposits in Euro currency and M3, according to Honohan and Shi (2002). The figure below presents the recording of an increase of the degree of Euroization from 21% at the beginning of 2007 to 31.4% in December 2009, this level decreasing as a result of the persistence of the difference between the interests for lei and for Euro and after decreasing the volatility of the rate of exchange.



Source: NBR, author's calculations

Figure 4. Evolution of the degree of Euroization

VI. Conclusions

The increase of the Euroization degree may be considered an opportunity for the economies which propose to adopt the unique European currency, meanwhile constituting a vulnerability if adopting the unique currency is delayed and if that economy is affected by the external shocks which induce a depreciation of the national currency. The partial Euroization of the Romanian economy has encouraged the overheating of the national economy until 2008, but it fractured the adjustment capacity of the shocks by means of the monetary policy and of the rate of exchange. Thus, a partial Euroization acquired a characteristic of a unilateral Euroization, in which the capacity of the economy to neutralize the shocks gets decreased and the dependence on the decisions of the Central European Bank, respectively of the economic agents from the highly commercially and financially integrated countries with Romania gets increased.

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