NOMINAL CONVERGENCE IN POST-ACCESSION ROMANIA

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Abstract

This paper aims to analyze the achievement of nominal convergence criteria by the Romanian economy, as well as the macroeconomic effects caused by the strong targeting of these criteria. The global crisis caused a small contraction of governmental expenditure but a fast-growing public debt. The policies restricting budget deficit and public debt continue to produce strong theoretical debates on the right way to reach economic growth.

Key-words: *convergence, budget deficit, public debt, GDP, monetary union*

JEL Classification: E_{61}, H_{61}, H_{63}

Introduction

In the last three years (2008-2010), as a result of the outstanding negative effects that have affected, in various degrees, the European economies, government concern became stronger over the performance of the nominal convergence criteria laid down in the Maastricht Treaty of the European Union. In February 1992, the main reasons for defining such criteria were related to the introduction of the common monetary policy, based on a single currency managed by an independent central bank.

After 1996, the Stability and Growth Pact aimed towards the coordination of national fiscal policies to ensure stability and prudence for budgetary climate, essential conditions for the success of Monetary Union.

Today, when the macroeconomic instability of several EU countries like Greece, Latvia, Ireland or Portugal has become a reality and the future of monetary union remains uncertain, the arguments for compliance of the nominal conditions are stronger and the speed required to achieve macroeconomic stabilization must be intensified.

Sometimes, during the crisis, the EU members who have experienced deep macroeconomic imbalances have questioned the optimal character of convergence criteria, even the possibility of relaxing them. In the near future, there is no chance to revise the Maastricht Treaty or the possibility of derogations from it.

This attitude comes even in the context in which several members of the Monetary Union faced with excessive budget deficits in 2009: Greece (15.4%), Ireland (14.4%) and Spain (11.1%) and with public debt above the level accepted by the Stability and Growth Pact: Greece (124.9%), Italy (118.2%), Belgium (99.0%) and Portugal (85.8%) in 2010.

Moreover, before such a situation, the European finance ministers agreed in the 2010 to strengthen sanctions against countries that fail to combat effectively the excessive budget deficit, in a term of grace granted, by the application of penalties that can amount up to 0.5% of GDP.

The challenges of global financial crisis

Fiscal deficit and public debt were the most affected nominal convergence criteria by current economic crisis. The influence of debt on macroeconomic stability and the ability to resume economic growth has been a constant concern since the Second World War.

J.E. Meade (1958), Franco Modigliani (1961), Paul Krugman (1988) have analyzed the long run implications of public debt on economic growth. They consider being a negative relation between high public debt and growth. Moreover, Krugman introduces the concept of „debt overhang", when the debt repayment ability of a country falls below the contractual value of the debt. We know that up to a certain threshold, the accumulation of external debt can be financed by investments, but beyond a certain level, investors will not be interested in financing this debt.

Robert Barro (1979) argued that government bond coupons must be finally paid from increased taxation. Regarding inflation, Barro found a link between high inflation and reducing the real cost of debt; the effectiveness of the inflation channel is quite sensitive to the maturity structure of debt.

Reinhart&Rogoff (2010) have shown that a higher public debt is generally associated with lower rates of long term growth (at a debt level over 90%). According to Reinhart&Rogoff, the EU public debt (about 88.5% in 2010) is still below the threshold at which growth is adversely affected. They suggest that the debt of many developing countries already may have a negative impact on GDP growth.

The opportunity to establish formal criteria for European economic convergence and the tension arise between nominal and real convergence were constantly concerns for Kenneth Rogoff (1996), Marius Marinaş (2006), Aurel Iancu (2008), Andrea Presbitero (2010), Reinhart & Rogoff (2010).

Most of these specialists argue that the desirability of nominal criteria is primarily determined by the European economy, which needs a harmonious economic development of their members that have chosen or wished to participate to Monetary Union. These nominal conditions are intended to remove any tensions between members, caused by the spread of negative effects of economic imbalance.

The latest collective study developed at European level, entitled Bruegel Report (2010) has failed to define the optimal set of economic policies favourable to long-term removal of existing imbalances or have been exacerbated by economic crisis, although they suggested a new economic model for the resumption of economic growth in the countries of European Monetary Union and especially among those who wish to adopt the European single currency.

However, the European economists have recommended to provide better conditions to potential candidates for the European Monetary Union membership, but adding new requirements in addition to those set by Maastricht Treaty, such as: the exchange rate is not overstated; the candidate must have already implemented devices to oversight the financial stability and the flexibility of own economy is adequately high to prosper after the integration into the Euro zone.

We must not forget the targets set in Copenhagen (1993) that proposed the adoption of European single currency by the new EU members within the shortest possible time.

Adopting the Euro currency is not the end of the complex process of convergence but rather its beginning. Entry into the Euro area does not mean removing the need to solve macroeconomic imbalances existing in the Member State wishing to join (Cristian Popa, 2009).

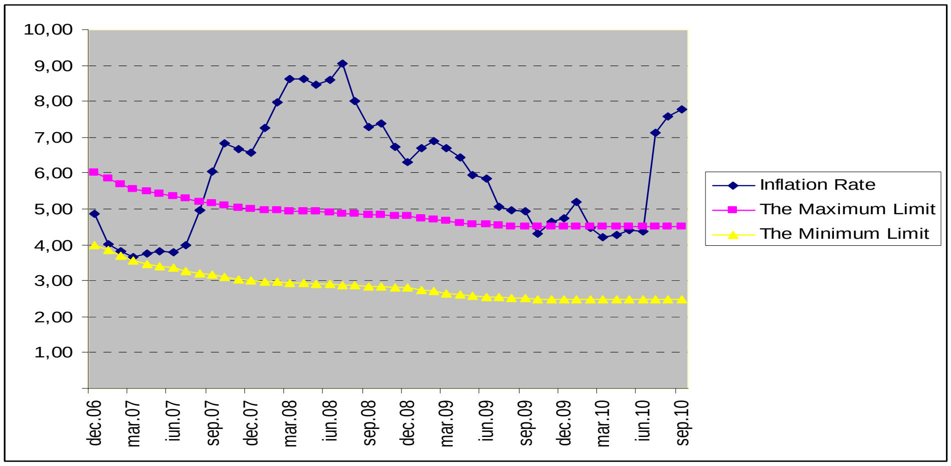
Macroeconomic trends in Romania

In Romania, the catching up process with the EU was based on an economic growth rate higher than the European average, but this growth has halted abruptly in the last quarter of 2008. Also, the process of real convergence has a strong partner in the productivity growth, more than 10% annually, led by very low initial levels, the progressive reduction of the rate of employment in agriculture and especially by the growth of foreign direct investments. This substantial increase in labour productivity has been brought forward by the accelerated growth of wages, leading to a worsening of external deficit and a further inflationary pressure (Mugur Isărescu, 2008).

The effects of economic crisis were felt in the most macroeconomic indicators since the beginning of 2009, on the one hand as a result of relatively low flexibility of the Romanian economy and on the other hand because of the inability of the Romanian government to immediately adapt its macroeconomics policies to a radically changed economic environment.

In Romania, the delay in taking solid measures of economic adjustment was determined by several election campaigns over the years 2008-2009, which postponed the unpopular decisions in the restrictive budgetary policies, fiscal and social right sectors, thereby prolonging the slope of the economic downturn and delaying economic recovery.

The disinflation or targeting inflation process of National Bank of Romania (NBR), which began in August 2005, failed to achieve the targeted margins, exceptions being 2006 and first two quarters of 2010.

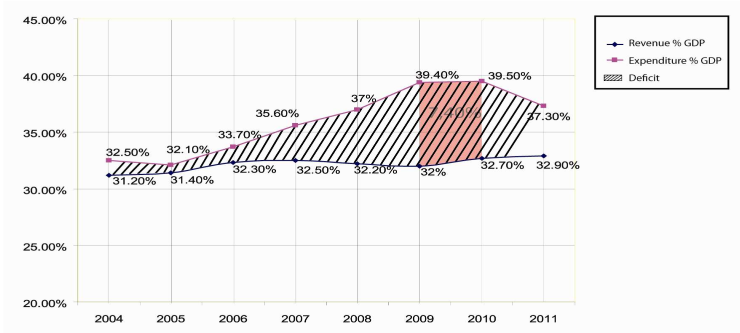


Source: *Inflation Report*, November 2010, from the National Bank of Romania
Fig. 1. *Inflation targeting in Romania (2006-2010)*

In 2010, the failure to target inflation was mainly driven by adjusting the minimum European duty level, by increasing the value added tax (VAT) from 19% to 24%, as a result of government failure to find alternative solutions to restrict the governmental expenditure, and the dynamics of imported food prices, due to limited domestic supply.

The NBR monetary policy has had an anti-cyclic nature, but nevertheless could not counter the massive inflows of foreign capital and the significant size of foreign currency credit. However, NBR has worked with successive reduction of the monetary policy interest rate from 10.25% to 6.25% in two years, during nine successive interventions and has reduced the minimum reserve requirements on deposits in domestic resources from 20% to 15% and from 40% to 25% for reserves in foreign currency.

The corrective depreciation of the domestic currency against the euro, from 3.6 Lei/ € in October 2008 to 4.2 Lei/ € in January 2010, has been an effective stimulator of the Romanian exports, especially inside the EU. In this context, the Balassa-Samuelson effect, based on the theory of faster productivity in the tradable sector of the economy and the fast growth of prices in the nontradable sector, has contributed an average of 1.5% inflation increase in the years 2009-2010, in almost the same parameters calculated for the years 1995-2004 (Altar, Albu et al, 2005)



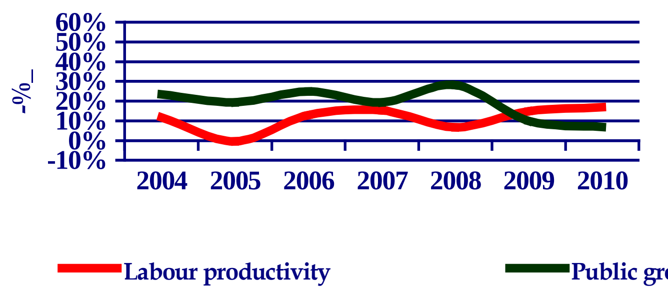
Source: *Fiscal and Budgetary Strategy for 2010-2013*,
from the Romanian Ministry of Public Finance
Fig. 2. *Romanian government revenue and expenditure (2004-2011)*

The budgetary and fiscal sustainability was certainly the most affected by the contraction of economic activities in Romania. To this economic reduction was added the lack of budget and fiscal reforms, making the construction of governmental budget with unrealistic expectations for revenue and wrong projections of economic growth, having continuing growth of expenditure, especially in social programs.

For example, in November, 2008 the budget projection for the next year, 2009, was built on an estimated nominal GDP of 578.5 billion Lei, compared to 491.24 billion Lei as was actually done (INS, March 2010). Budget revenues over 38% of GDP were also anticipated, while the income earned in the last five years have not exceeded 32% of GDP. In this economic environment, the budget deficit since 2007 has increased progressively until 2009, over the 3% limit, by the national evaluation methodology.

According to **ESA 95** methodology the budget deficits for the years 2008 and 2009 were higher by over one percent against the national results.

It should also be noted that income expectations were unrealistic and based on a short term excess of demand, caused by an unsustainable increase in incomes, by increasing the wages more than labour productivity or by exceeding growth in consumer credit.



Source: *Romanian Statistical Yearbook 2010*, Romanian National Institute of Statistics
Fig. 3. *Wages – Labour Productivity Correlation in the Public Sector*

For example, if we eliminate the cyclical component of incomes (method used by IMF, OECD and EC), one can see more clearly the true magnitude of fiscal deficit of 4% in 2007 (+1.5%) and 8.5% in 2008 (+3.15) compared to the officially reported 2.5% and 5.4% (Florin Georgescu, 2010)

The strong need to finance the budget deficit led to an expansion of Romanian public debt. However it is still lower than the Maastricht standards, under the 60% of GDP, but its growth in the last years is quite significant, from 30% of GDP in 2009 to 37.3% in 2010, with the expectation of moderate growth in 2011 to 39.5% of GDP. The risks associated to the short and medium term debt is relatively low, primarily grace to their small size on short term and then to the financial agreement with the International Monetary Fund and European Commission.

The 2010 was a favourable moment for public finances in Romania, by adopting the Fiscal Responsibility Law (no. 69/2010), which established the duty of Romanian government to elaborate its medium-term fiscal strategy, an extremely important document for the development of a prudent fiscal policy aimed to strengthen fiscal discipline.

In Romania, the most part of the restructuring policies has been driven by requirements established in the external financing agreements with IMF and CE, which set several sine qua non obligations for macroeconomic stabilization. Only after reaching these obligations, the International Monetary Fund and European Commission have released the tranches for NBR, but also for financing excessive budgetary deficit.

The potential risks related to political factors still remain (Lucian Croitoru, 2010) because the reforms initiated in these years need a consistent political support to the medium and long term, and the next period 2012-2014 will be characterized by new electoral campaigns, which may lead to new social and economic falls.

As regards of fiscal consolidation, although in Romania there is a large number of taxes, the share of budgetary revenues in GDP has not increased significantly, fluctuating around 32% of GDP, against the European average of 40% of GDP. The level of revenues was not influenced by any adopted tax model: either a progressive or single rate tax.

Most of the explanations for this discrepancy are related to excessive growth of smuggling, to increase of informal labour relations and to higher tax evasion, spurred by weak or corrupted fiscal institutions.

The exchange rate of national currency has been framed in the stability requirements. Despite the corrective depreciation of national currency, foreign exchange rate fluctuation margins were maintained within ± 15%, with a variation of 1.71/-14.3%, calculated as the maximum deviation of the exchange rate against the euro between November 2008-October 2010 compared with the average recorded in October 2008 based on daily data (NBR, *Monthly Newsletter November* 2010).

Long-term interest rates for the benchmark between September 2009 and August 2010 were 1.3% above the average of three best performing members of the euro area even more than the margin of 2% (6.3%), so a real rate of 7.6% for the year 2010.

Conclusions

Between 2008 and 2010, strong macroeconomic imbalances have led to a reassessment of the period for adopting the single currency for several EU member states, including Romania; except Estonia, a small state, which became a member of Euro zone in January 2011.

Analyzing the moderate rhythm of economic reforms and the state of the main macroeconomic index, we may affirm that the date January 1, 2012 may be still sustainable for Romania to join the Exchange Rate Mechanism II, only on the condition that it should conclude in 2011 a new funding agreement with IMF. This new agreement will aim to give not only a psychological signal to international markets, but also to impregnate continuity for national reforms, without delaying or altering them by the electoral events, that will take place from 2012 to 2014.

The new agreement with the IMF can be very useful especially in the international context of frozen credit markets.

If Romania chooses the second scenario or *the second best*, the date of 1st January 2013, for the last stage before adoption of Euro, the Exchange Rate Mechanism II, the delay can be seen in a dual effect, not only as a failure point.

On the one hand, by extending the period of delay, the implementation of structural reforms can be achieved. These transformations are expected over two decades by the Romanian economy and society, especially on social benefits and public sector employment.

A year of delay will allow a greater deepening of convergence in real terms (GDP per capita, labour costs, the share of GDP in the formation of branches of national economy or the degree of openness of the economy) and business cycle synchronization between the euro area and Romania, to keep away from risks associated with asymmetric shocks. The monetary policy autonomy will be extended, especially the autonomy on the exchange rate to stimulate exports.

On the other hand, if the rescheduling will be transformed into an indefinite delay, it can reduce the consistency of the structural reforms initiated in time of crisis. It also will maintain currency risk conditions, and high transaction costs, adverse effects on investment and growth. We must also take into account the negative impact on the international capital markets.

Resumption of growth of the Romanian economy could be helped, no doubt, by the absorption of EU funds, up to values of 4% of GDP. If a financial instrument such as grants will be used in the next three years, funds may lead to the resumption of GDP growth and significant reduction in fiscal deficit. This is the last emerging problem for the Romanian economy, but the most difficult to eradicate in the current domestic and international context.

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