THE ANALYSIS ON THE PREPARATION DEGREE OF THE EASTERN EUROPE BLOCK STATES TO ADOPT THE UNIQUE CURRENCY

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Abstract:

The entry ticket for the Economic and Monetary Union and for adopting the single currency is obtained when an EU member country achieves the five nominal convergence criteria stipulated in the Maastricht Treaty. Since the launching of the euro on 1 January 1999 by 11 European Union member states, another five countries joined theeuro. Out of the 27 EU countries currently only 16 Member States have adopted the euro at most recent case in this regard is Slovakia on 1 January 2009. This means that 11 states have not yet adopted the euro and are fully participating in the third stage of the economic and monetary union. The idea of this paper appeared amid the advance preparation of the Eastern block countries in the European Union to the admission to a higher stage of integration. After analyzing the status of compliance with the convergence criteria of the Eastern bloc countries in the EU, of Romania in particular, we came to the conclusion that ***Romania does not comply with any of the criteria for adopting the single European currency, with all the progress made in terms of European integration, so it is shown that efforts must be intensified*** *in order to achieve a high degree of sustainable convergence. This effort is aimed at making and maintaining price stability in a sustainable manner, as well as reducing the large deficits incurred during the financial and economic crises, in some Member States and to achieve and maintain an optimal level of the public finances.*

Keywords: Monetary Union, nominal convergence criteria, inflation, budget deficit, public debts, real convergence,

JEL Classification: E 42

INTRODUCTION

The currency revolution, embodied by the euro, involves more than the elimination of national currencies and distributing colorful banknotes and coins throughout Europe. It entails the unification of the common market of goods and services of the European Union, major structural changes in countries characterized by reckless fiscal and monetary policy, and the reorganization of some of the most advanced industrialized economies of the world. The process of the admission of Eastern Europeans in the European Union and subsequently in the euro area, raised a number of questions relating to the compliance with the convergence criteria for the Economic and Monetary Union.

In the analysis of the status of compliance with the convergence criteria, the sustainability is of critical importance. Adopting the euro is an irrevocable process; therefore the convergence process should be done in a sustainable manner, not only within a certain time. In order to achieve a high degree of sustainable convergence, the efforts of all countries surveyed have increased significantly. This effort is aimed at achieving and maintaining price stability needed in a sustainable manner, as well as reducing the large deficits incurred during the financial and economic crisis in some Member States and to achieve and maintain an optimal level of public finances. This paper presents an analysis of the criteria for nominal and real convergence for a part of thr central and eastern European countries, focusing in particular on the case of Romania.

1. ANALYSIS OF NOMINAL CONVERGENCE

1.1. Sustainable price stability criterion. According to this criterion, the inflation rate should not exceed 1.5% average of the three countries with the lowest inflation rates. This criterion involves a high degree of monetary policies convergence. It is important for the inflation rates to converge within a union, because states that have a higher inflation than others suffer a loss of competitiveness that can not be corrected through devaluation (Toma, 2004). Also, for the benefits of the Single Market, the Member States must meet the requirement relating to price stability. Considered as a condition for exchange rate stability, price stability allows the euro single currency to emerge as the strongest currency against other currencies.

Table no. 1. Inflation rate (%)

Country / year	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Bulgaria	10,3	7,4	5,8	2,3	6,1	6,0	7,4	7,6	12,0	2,5
Poland	10,1	5,3	1,9	0,7	3,6	2,2	1,3	2,6	4,2	4,0
Czech Republic	3,9	4,5	1,4	-0,1	2,6	1,6	2,1	3,0	6,3	0,6
Romania	**45,7**	**34,5**	**22,5**	**15,3**	**11,9**	**9,1**	**6,6**	**4,9**	**7,9**	**5,6**
Slovakia	12,2	7,2	3,5	8,4	7,5	2,8	4,3	1,9	3,9	0,9
Hungaria	10,0	9,1	5,2	4,7	6,8	3,5	4,0	7,9	6,0	4,0
EU-15/ EU-27	1,9	2,2	2,1	2,0	2,2	2,2	2,2	2,3	3,7	1,0
First three states with smallest inflation average	1,2	1,6	1,4	1,2	1,1	1,4	1,6	1,8	2,6	0,1
Entry criterion	2,7	3,1	2,9	2,7	2,6	2,9	3,1	3,3	4,1	1,6

Source: CEB, NBR, Eurostat database

Along with Bulgaria, Romania is an EU member state that records a relatively high level of inflation compared with other members. Not fulfilling this criterion by Romania means, in fact, the Romanian economy macroeconomic stabilization process's lack of sustainability (Socol, 2008). Retrospective analyses show that in Romania, consumer price inflation has been placed on a clear downward trend, although showing in the reference period a very high level, namely 45.7%. Disinflation experienced in the context of strong real GDP growth, which exceeded the 5.0% level in almost every year since 2001. Disinflation has occurred against the backdrop of accelerated labor income, which exceeded 20% over several years.

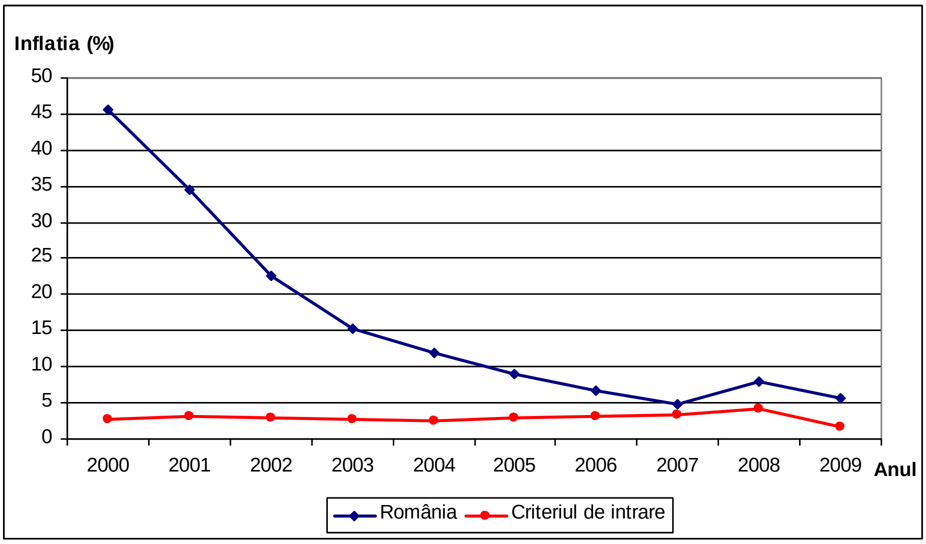

Figure no. 1. Evolution of the average annual change in the HICP of Romania compared to the euro zone entry criteria

Source: ECB, the central bank, the Eurostat database

The year 2004 was the first year with inflation expressed by a single digit in the period after 1990, the inflation rate in December being 9.3%. If by the end of 2004 the NBR managed to significantly reduce the inflation rate, 2005 was marked by the slowdown in disinflation (Socol, 2008). Thus, the inflation target was exceeded by 1%, reaching an average rate of inflation 9.1%. The next year meant the continuation of the disinflation process, at the end of it reaching a target of 4.87%. The annual inflation rate accelerated to around 4% in January-July 2007 period to 8.7% in March 2008. In 2009 the average annual inflation rate for Romania was at 5.6%, considerably higher compared to reference value of 1.6% corresponding to the criterion on price stability. In April 2009 Romania had the highest annual rate of inflation in the European Union, 6.5%, while the annual rate in the euro area remained unchanged in April 2009, at the record level of 0.6% and in the European Union decreasing slightly, to 1.2% from 1.3% the previous month, according to revised estimates published by the European Statistics Office. The Central Bank's monetary policy strategy is direct inflation targeting. Given that the Romanian economy is undergoing a process of disinflation - the pace of inflation over the medium term sustainable and compatible with the quantitative definition of price stability is not yet reached. The inflation evolution over the past decade must be considered in the context of a robust growth of GDP by mid-2008, followed by a sharp decline in economic activity (Toma, 2004) in the international financial crisis.

1.2. Budget deficit criterion. According to this criterion, the government deficits of the Member States of the Union who wish to adopt the single currency can not exceed 3% of gross domestic product. Controlling the budget deficit was imposed in order to avoid situations in which states have no way out other financial than inflation, which could compromise the credibility of monetary union.

Table no. 2. Budget deficit (-) / surplus (+) to GDP (%)

Country/year	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Bulgaria	-0,3	0,6	-0,8	-0,3	1,6	1,9	3,0	3,4	1,8	-3,9
Poland	-3,0	-3,7	-3,3	-4,5	-4,8	-4,3	-3,9	-1,9	-3,7	-7,1
Czech Republic	-3,7	-5,9	-6,8	-6,6	-3,0	-3,6	-2,6	-1,6	-2,7	-5,9
Romania	**-3,6**	**-3,5**	**-2,0**	**-2,0**	**-1,4**	**-1,4**	**-1,9**	**-2,3**	**-5,4**	**-8,3**

Slovakia	-12,3	-6,6	-7,8	-2,8	-2,4	-2,8	-3,5	-2,2	-2,3	-6,8
Hungaria	-3,0	-3,5	-8,9	-7,2	-6,4	-7,8	-9,2	-5,0	-3,8	-4,0
EU-15/ EU-27	0,6	-1,4	-2,5	-3,1	-2,9	-2,5	-1,4	-0,8	-2,3	-6,8
Entry criterion	-3,0	-3,0	-3,0	-3,0	-3,0	-3,0	-3,0	-3,0	-3,0	-3,0

Source: Marius Marinas, Economic convergence, Economic Publishing House, Bucharest, 2008; the Eurostat database

Compared with the states analyzed, Romania is after Bulgaria in the budget deficit values obtained during 2000-2009. This indicator has seen a downward trend until 2005, when it amounted to -1.4%. In 2006, the budget deficit rose to 1.9% of GDP, and this upward trend has continued until today. Thus, in 2007, Romania registered a budget deficit of 2.5% of GDP, lower than the reference value of 3%. Although the European Commission has forecast an increase in the deficit to 2.9% in 2008, the budget deficit has doubled. For Romania to maintain a share of the deficit below the reference value and meet the medium-term objective set out in the Stability and Growth Pact it was necessary to continue fiscal consolidation. In regard to other fiscal indicators, in 2006 and 2007 the magnitude deficit in GDP did not exceed public investment.

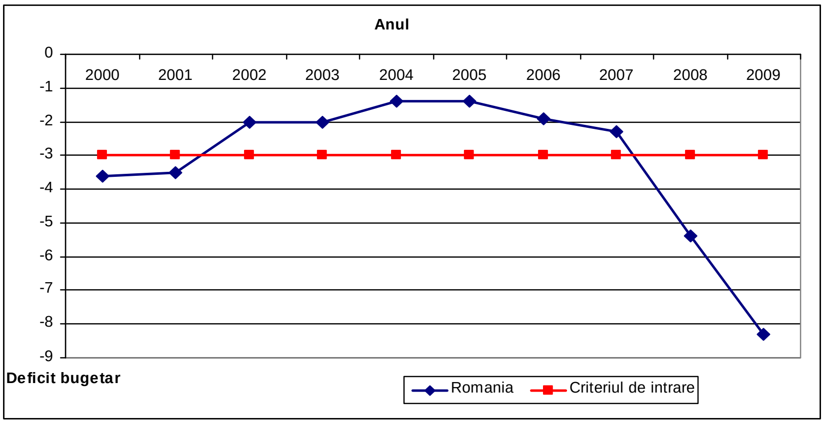

Figure no. 2. The evolution of Romania's budget deficit compared to the eurozone entry criteria

Source: Eurostat database

In 2009, Romania registered a budget deficit of 8.3% of GDP, far higher than the reference value of 3%. So our country is subject to EU Council decision on existence of excessive deficit. In respect of other tax indicators, the deficit ratio exceeded the share of public investment in GDP in 2009 and expected a similar situation in 2010. Romania also faces serious risks in terms of sustainability of public finances. We can say that the slow pace of consolidation of public finances sustainable in Romania has high costs and long-term average. The sharp increase in pensions, the unwise wage policy, the avalanche of populist legislative initiatives in parliament, and the inconsistent fiscal policy represent elements that have favored the consolidation of a serious imbalance in public finances. To prevent deterioration of economic and financial situation, the Romanian authorities have requested and negotiated a financial package on two years in March 2009, with the IMF, the European Community and other international financial institutions (World Bank, EIB, EBRD) worth 19.95 billion euro.

1.3. The public debt criterion. According to this criterion, the debt can not exceed 60% of gross domestic product. When a State resorts to borrowing, to cover budget deficit, for the repayment thy should obtain a primary surplus by cutting spending and increasing revenue (Toma, 2004). Otherwise, the debt grows more and with it the annual amounts to be repaid. On the other hand, a government might be tempted to use the money issue to cover the debt. The Maastricht Treaty prohibits the issuance of money that aims to reduce the actual debt because of its inflationary nature.

Table no. 3. Gross public debt to GDP (%)

Country/year	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Bulgaria	74,3	67,3	54,0	46,3	37,9	29,2	22,7	18,2	14,1	14,8
Poland	36,8	36,7	42,2	47,1	45,7	47,1	47,6	45,2	47,2	51
Czech Republic	18,2	25,3	28,8	29,8	30,4	29,8	29,4	28,7	30,0	35,4
Romania	**22,5**	**25,7**	**23,3**	**21,3**	**18,8**	**15,8**	**12,4**	**13,0**	**13,6**	**23,0**
Slovakia	49,9	48,7	43,3	42,6	41,4	34,4	30,4	29,4	29,2	35,7
Hungaria	55,0	52,0	56,6	58,4	59,1	61,8	65,6	65,9	72,9	78,3
EU-15/ EU-27	61,9	61,0	61,4	63,3	63,8	62,9	61,7	59	61,6	73,6
Entry criterion	60,0	60,0	60,0	60,0	60,0	60,0	60,0	60,0	60,0	60,0

Source: Eurostat database

According to the information in the table above, we can say that Romania is the state which recorded the lowest levels of public debt to GDP among all the states analyzed.

In early 1990, Romania's external debt paid in full and had to receive from Iraq claims worth \$ 2.5 billion, debt that was partially canceled and the rest rescheduled (Socol, 2008). In addition, it had reserves of approximately 1 billion euros. This was the result of irrational economic policies of forcing exports and the exaggerated amputation of imports. Subsequently, the discrepancy between the mechanism of resource allocation and economic performance, the adjustment forced "tense" of the economy balance, have led to serious discrepancies in the system and gave the economy a "normal" state of "stable disequilibrium" (Brezeanu, 2007) .

Retrospective analyses for Romania indicate that the gross government debt recorded a relatively downward trend until 2006, when it obtained the lowest value, namely 12.4%. 2007 marked the increase of this indicator’s value from 13% to 23% today.

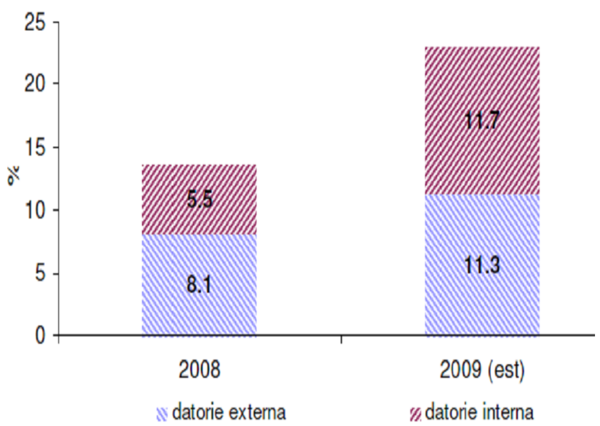

Figure no. 3. The structure of government debt in Romania
Source: Ministry of Public Finance

Currently, Romania's public debt level is below 25% of GDP, well below the 60% ceiling set by the Maastricht Treaty. Thus, at the end of 2008 the government debt calculated according to EU methodology represented 13.6% of GDP, while in late 2009, amid the deepening international financial crisis and deepening recession in Romania, this indicator was 23.0% of GDP, of which domestic debt 11.7% and 11.3% external. For Romania, the financing necessary to complete the internal resources generated external debt which stood within sustainable parameters over the period analyzed. Since debt service in coming years will reach peak levels, and concrete results in the Romanian economy are not yet comparable to the objectives of reform programs, the integration of external debt management and the internal indebt strategy is imposed within the macroeconomic policies developed by decision makers (Brezeanu, 2007).

1.4. The interest convergence criterion. According to this criterion, long-term interest rates can not exceed by more than 2% the average of the three countries with lowest inflation. This criterion addresses two key issues: interest rate, which is determined by market supply and demand and the anticipated rate of inflation (Toma, 2004). The convergence of long-term interest rates means the convergence of expected inflation rates, the latter in turn reflecting the fact that the monetary policies of different countries have reached a level of homogenous credibility.

Table no. 4. Nominal long term interest rates (%) (calculated for 10-years maturity bonds)

Country/year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Bulgaria	-	-	-	6,4	5,3	3,8	4,2	4,8	5,4	7,2
Poland	-	10,7	7,3	5,7	6,9	5,2	5,2	5,5	6,0	6,1
Czech Republic	-	6,3	4,9	4,1	4,8	3,5	3,8	4,3	4,6	4,8
Romania	**-**	**-**	**-**	**-**	**-**	**6,7**	**7,2**	**7,1**	**7,7**	**9,6**
Slovakia	-	8,0	6,9	4,9	5,0	3,5	4,4	4,5	4,7	4,7
Hungaria	-	7,9	7,0	6,8	8,2	6,6	7,1	6,7	8,2	9,1
EU-15/ EU-27	1,2	1,6	1,4	1,2	1,1	1,4	1,6	1,8	2,6	0,1
Criteriul de intrare	3,2	3,6	3,4	3,2	3,1	3,1	3,6	3,8	4,6	2,01

Source: Eurostat database

Looking back, the nominal long term interest of Romania has seen a descending path. Thus, this rate increased from 6.7% in 2005 to 9.6% in 2009. Referring to the same period, we can say that long-term interest rates in Romania have soared in the context of high levels of investor aversion to risk and uncertainties relating to economic prospects. During the period April 2007 - March 2008, long-term interest rates stood at an average of 7.1%, a benchmark higher than the interest rate criterion, of 4, 6%. In the second half of 2009 long-term interest rates were located on average at 9.4%, significantly higher than the reference value corresponding to the interest rate convergence criterion. In recent years, long-term interest rates in Romania have soared in the context of high levels of investor aversion to risk and uncertainty surrounding the economic outlook. Recently, these indicators have registered a downward trend but continued to place relatively high, and the associated long-term interest rate bonds issued by the Romanian state was 7.1% in March 2010. Creating an environment conducive to the sustainable convergence in Romania requires, among other things, a stability-oriented monetary policy and strict implementation of consolidation plans. As a result of the Romania's integration into the European Union deepening, the country's rating is likely to be high, and our country will be able to emerge on the public markets and private external capital bonds with a maturity of ten at a rate of interest that meet the criteria set by the Treaty of Maastricht (Socol, 2008).

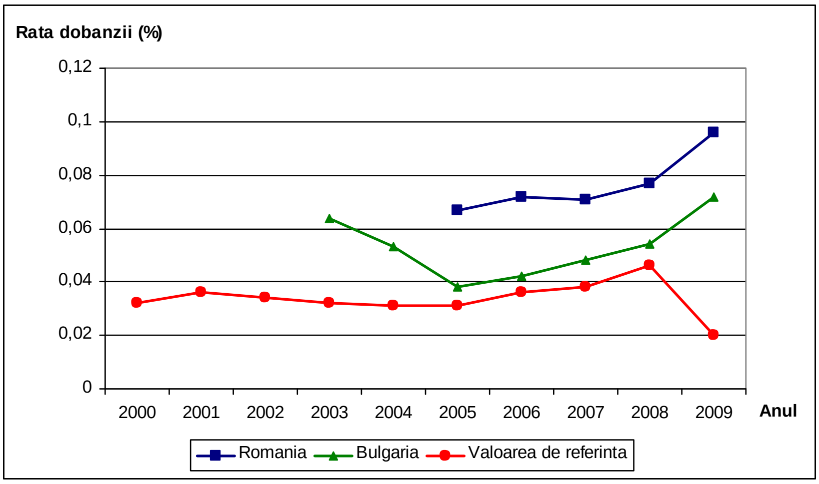

Figure 4. **Evolution rate compared to the reference value for Romania and Bulgaria**
Source: Eurostat database

2. ANALYSIS OF ROMANIA'S REAL CONVERGENCE

The analysis of the Romanian economy's real convergence with the European model may begin with the analysis of known *GDP per capita at purchasing power parity*. In 2008, Romania has recorded a 42.5% value afferent to this indicator related to the EU average. In addition, this value is lower than that obtained by the Czech Republic (82) but higher than the figure recorded in Bulgaria (39%). A year later, the GDP per capita at purchasing power parity standard (PPS) in our country stood at 45% of the EU average, Romania occupying the second lowest in the EU, ahead of Bulgaria, where GDP per capita expressed in PPS was 41% of the EU.

The literature shows that successful real convergence of a state depends on the *evolution of labor productivity*. Thus, increasing wage growth causes economic growth and increasing living standards. An average growth rate of labor productivity per person employed of 10% per year can be an engine of a quickly sustainable catching-up process. In 2007, the average labor productivity increased by 11% over the previous year. In 2008, Romania was the second lowest among the EU Member States; the productivity per person employed was 43%.

Another index of real convergence of our country is to increase business investment as a share of GDP. It is necessary that this indicator to be correlated with labor productivity growth. In essence, increasing business investment shows the GDP weight that the private sector uses for investments. For Romania, this indicator's recorded values are higher than the EU average. This underlines the high potential of the Romanian private sector development, especially through technology transfer, know-how, management techniques, made by foreign direct investment (Socol, 2008).

Table 5. Business investments

State/year	2003	2004	2005	2006	2007
Bulgaria	16,6	17,6	20,0	21,8	25
Romania	**18,2**	**18,9**	**19,3**	**22,8**	**n.a.**
Hungaria	18,6	18,9	18,8	17,3	17,3
EU-15 / EU-27	17,1	17,3	17,8	18,2	n.a.

Source: Eurostat database

The FDI in the Romanian economy and the attraction of the largest possible European funds could solve some of the structural problems of the national economy. For example, foreign direct investment based on the transfer of technology increases the speed of convergence. They are a stable source of financing the current account deficit. Romania's advantages in attracting investment of this type refer to: domestic market size, proximity, level of taxation, the unit cost of labor, low political risk and the importance given to the privatization process. FDI flows have been attracted mainly by the low cost of labor and did not significantly affect the structure of the Romanian economy. These were mainly related to the privatization process.

Also, specialists in macroeconomics recommended the states in transition to develop their infrastructure for the catching-up process to be quick. As regards our country, public investment in recent years have increased yearly, aware that economic modernization means the highways, telecommunication networks, adequate public utilities, etc. (Socol, 2008). At present, Romania ranks last in Europe in terms of kilometers of highway built. The total length of highways at the end of 2009 amounted to 303 km.

In regard to the structural and cohesion funds granted by the European Union, they represent one of the main ways of financing investment projects in infrastructure. According to the EU financial perspective, the funds allocated to Romania in 2007-2013 amounted to 19 billion euros (Socol, 2008). Although disposing of these funds, the capacity of their absorption by Romania is extremely low. Low absorption capacity can be attributed to lack of eligible projects, institutional mechanisms and financing opportunities. Perhaps the most important constraint in accessing the European funds is the complete co financing of European projects while respecting the nominal convergence criteria on budget deficits in the same time. With a budget deficit of 8.3% and a share of budgetary revenue in GDP of 32.1% in 2009, it will be very hard for Romania to co-finance any part of the European project of modernization.

A final indicator that it should be noted is the structure of the Romanian economy sectors. Between 2000-2007, it was not as substantially modified. Although agriculture's contribution to GDP dropped in the range of reference, this reduction is not significant. Relatively low share of services in GDP is a determining factor in terms of structural differences compared to the European Union. Analyzing the composition, there is a weak development of services to businesses, public services, tourism.

Table 6 Evolution of the national economy sectors, in relation to GDP (modifications compared to the previous year)

Sector / year	2007	2008	2009*
Industry	5,4	1,9	-4,3
Agriculture	-15,3	21,9	-2
Constructions	33,9	26,1	-18,9
Services	7	5,4	-5,6

* National Forecast Commission estimates

Source: Convergence Programme issued by the Romanian government

To achieve rapid real convergence with EU countries, Romania is supposed to stimulate labor productivity growth at a higher rate than the exchange rate appreciation against the euro and should apply a mix of measures to attract foreign direct investment. Also, structural and cohesion funds must be given to the regions near the center, in the form of concentric circles outward in order to improve cohesion.

CONCLUSIONS

In conclusion, our country does not fulfill any of the criteria that would enable it to adopt the European single currency. Also, the Convergence Report adopted by the European Commission in

May 2010 highlighted that Romania does not comply with any criteria in order to adopt the single European currency with all the progress made in terms of European integration. The document analyzes developments of the Romanian economy and finds that the Romanian authorities have not achieved sufficient progress for the euro. Creating an environment conducive to sustainable convergence in Romania requires, among other things, a stability-oriented monetary policy and strict implementation of consolidation plans. However, Romania faces with numerous challenges in terms of economic policies.

Although authorities have announced that they would like the changeover to take place in 2015, this is not possible since the instability of prices and exchange rates, budget deficit and long-term convergence of interest and legal framework for entering the race disqualify Romania in the euro area. BNR Governor Mugur Isarescu said recently that it is best for Romania to adopt euro slightly later than the original schedule, but to do this step before being ready. Romania does not seem interested at the moment in the accession to Euroland in 2015 as it was expected, a reasonable time horizon being 2018, say sources in the financial system since costs of the adoption of the euro would now be higher than the benefits.

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