

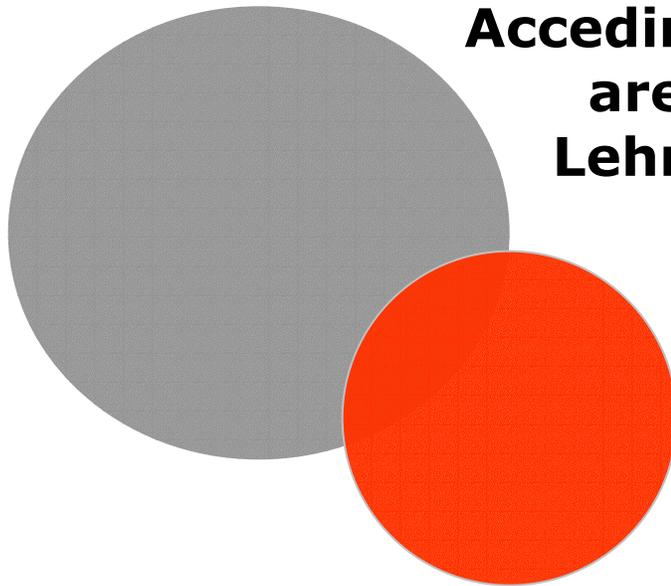


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Initiative

Open Society Institute – Sofia

Country Report ROMANIA

Economic and Political Challenges of Acceding to the Euro area in the post- Lehman Brothers' World



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Sofia, October 2009

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The publication is a product of the Open Society Institute – Sofia within the European Policies Initiative (EuPI) and the project “Economic and Political Challenges of Acceding to the Euro area in the post-Lehman Brothers’ World”.

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The publication comprised of nine Country Reports and a Summary Report is available on the website of the European Policies Initiative: www.eupi.eu

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The European Policy Initiative (EuPI) aims at stimulating and assisting the New Member States from CEE to develop capacity for constructive co-authorship of common European policies at both government and civil society level. As a new priority area of the European Policies and Civic Participation Program of Open Society Institute – Sofia, EuPI will contribute to improving the capacity of New Member States to effectively impact common European policies through quality research, policy recommendations, networking and advocacy.

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The project was implemented from September 2008 to September 2009. The main outcome of the project is a publication comprised of nine Country Reports and a Summary Report.

Following a uniform structure, and addressing a set of similar questions, the nine Country Reports (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and Slovenia) present stylized facts about the patterns of real and nominal convergence with the euro area in nine new EU members, outline the setting and the implementation of the accession policies in those countries and emphasize the incidence of the current crisis on the strategy to adopt the common currency.

Comments are relevant to policy developments until 20 May, 2009 – the cut-off date for the submission of the last revised version of the Country Reports.

The Summary Report reviews the results of the Country Reports and systematizes some of the dominant trends they reveal. The Summary Report checks the countries’ experience in dealing with the complicated concentric monetary structure inside the EU (euro area; ERM II; non ERM II countries) and pays particular attention to the evidence gathered about the political economy of the procedures in the different countries.

Each Country Report and the Summary Report include an Appendix, containing Tables that summarize significant data provided in accordance with a standardized set of indicators.

The results of the Project are correctly intelligible only if all its pieces (ToR, Summary Report, Country Reports, Appendix) are considered together.

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EXECUTIVE SUMMARY

Romania's real convergence process to the European Union (EU) benefited from nine consecutive years of high growth rates (2000-2008). GDP per capita reached 43% of EU average, almost double than in the previous decade, but the main drivers of this economic growth were very volatile sectors such as construction and services as led by household consumption. For its part, household consumption was fuelled by excessive credit activity by the foreign banks operating in Romania. This led to unsustainable current account deficits (13-14% of GDP in 2007 and 2008) and, in an inappropriate policy mix with an expansionary fiscal and budgetary policy, to a high budget deficit at the end of 2008 (-5.4% of GDP).

Romania currently fulfills two of the five Maastricht criteria: public debt and exchange rate volatility. The most challenging nominal convergence indicators are inflation and budget deficit.

To protect the local currency from depreciation after potentially high capital outflows, Romania concluded a €19.95 billion stand-by agreement with the International Monetary Fund (IMF) in May 2009, which is an opportunity in disguise to discipline Romania's public finances and to finally make long-postponed structural reforms. Most of it (€12,95 bn.) goes to supplement the foreign exchange reserves of the National Bank, while the remainder – coming from the EU, World Bank, European Bank of Reconstruction and Development (EBRD) and European Investment Bank (EIB) – help financing the budget deficit.

The tentative target for entering the ERMII is 2012; 2015 is an indicative target for joining the Euro area. The sharp adjustment in the current account deficit, which started in early 2009, and the current freezing of the non-governmental credit, both could help to keep the adjustment period within the medium term (three years), therefore supporting Romania's ERMII accession in 2012. This is currently the working scenario and *ceteris paribus*. It is also the most likely scenario, in my view.

In this paper we analyze two more extreme policy options, namely unilateral adoption of the euro or postponement of euro adoption, but the best choice remains the current approach. Romania should not adopt the euro ahead of schedule. Moreover, euro adoption should not become the ultimate goal, but a normal result of undertaking the necessary fiscal and structural reforms. How long does it take is less important than getting it right.

I. Romania's economic convergence

Romania has made marked progress in the past five to six years by transitioning from a factor-driven economy (based on natural resources and cheap labour) to one driven by investment. High rates of growth in GDP, an increasing share of fixed capital formation, and large inflows of foreign direct investment seem to color Romania as a catching-up economy.

However, development is uneven (there are large inter-regional gaps), real convergence is still a long way off, and vulnerabilities have become evident. Economic growth has been fuelled by household consumption, based on a combination of rising wages (which outstrip productivity gains) and a credit boom. The flat tax introduced in 2005 added fuel to the fire, stimulating consumption in an over-heating economy. Pro-cyclical fiscal and wage policies pose a major risk for the economy; in particular, the public sector of the economy is oversized.

This, in turn, has stimulated imports. The current account deficit has widened from 5% of GDP in 2002 to 14.2% in 2007, with a moderate adjustment to 13% of GDP in 2008. It would have been around 20% had it not been for foreign remittances. Private debt increased four times over the last four years (2005-2008) and has become a major issue for the economic stability and the main reason to justify the need of an IMF loan which was negotiated and agreed upon in March 2009.

The global economic crisis adds to important pressures on the Romanian economy: a sustained further contraction of access to private external funding, and a weakened external demand (as 70% of Romanian exports are bound for euro area markets).

Romania neglected to take full advantage of its first two years of EU membership, as it was a net contributor to the EU's budget in both 2007 and 2008, if pre-accession funds are excluded. The absorption rate of EU structural funds was in fact 0% in 2007 and around 5% in 2008. Most worrying, Romania lost the sense of direction it had during the accession process. Local ownership of reforms is limited, and a clear post-accession strategy is still absent.

Euro adoption could therefore play a strategic role for Romania's macroeconomic policy mix, as it would entail more severe fiscal and monetary conditions and a number of structural reforms.

Regarding the nominal convergence criteria, Romania fulfilled 2 of them by the end of 2008 (see Table 1).

Table 1: Romania and the nominal convergence indicators, 2008

Nominal convergence indicators	Maastricht criteria, reference level as of end of 2008	Romania, end of 2008
Inflation rate	4.1%	7.85%
Long term interest rate	6.2%	7.7%*
Exchange rate**	+/- 15%	+9.7% / -14.6%
Budget deficit***	Less than 3% of GDP	5.4%
Public debt	Less than 60% of GDP	13.6%

*Shorter than 10 years maturity for Romania, while the reference level is calculated for 10 years maturity.

** Calculated as the maximum deviation of the RON/Euro exchange rate during 2007-2008 compared to the average value in December 2006.

*** Calculated according to ESA95 methodology

Source: the author, based on Eurostat and NBR

These two indicators are public debt, which is very low, but is expected to expand rapidly during 2009 (the IMF loan leads by itself to a double public debt in 2009 compared to 2008); and exchange rate volatility, although the RON depreciation came very close to the 15% threshold. Furthermore, for some years, Romania has met the public finance criteria, but the surge in public expenditures in the electoral year 2008, adding to a growing structural deficit, bringing the budget deficit to more than 5% of GDP, way over the Maastricht target. Inflation is one of the most difficult convergence indicators for Romania; the spread between the euro area inflation and the Romanian inflation even increased to more than 4 percentage points in the first quarter of 2009.

II. National goals and strategies for the Euro adoption

The objective of euro adoption has never been an immediate objective for Romania. Nevertheless, the most important macroeconomic policy decisions - such as the measures towards achieving macroeconomic stability, implementing the disinflation program, and liberalization of the capital account - were taken in order to comply with EU accession conditionality. This helped, by default, the more distant euro adoption target.

The chronology of key policy decisions and events in this process contains the following milestones:

- 1998 – full liberalization of the current account;
- 1999 – restructuring the banking system (privatization, consolidation, improved regulations);
- 2001 – beginning of the liberalization of the capital account;
- 2001 – a stand-by agreement with IMF (the agreement was successfully completed in 2003), containing conditionalities regarding the elimination of the quasi-fiscal deficit and a disinflation program;
- 2004 (December) – full liberalization of the capital account, with few exceptions regarding derivatives market and land purchase by foreigners (these restrictions were removed by end of 2006);
- 2005 (July) – the National Bank adopts the inflation targeting strategy;
- 2007 (January) – Romania joins EU;
- 2007 (November) – the first Convergence Programme sent by the Romanian Government to Brussels, mentioning 2014 as an indicative target for euro adoption.
- 2009 – the new Romanian Government reconfirms 2014 as the target for euro adoption.
- 2012 – indicative target for entering the ERMII;
- 2014 – indicative target for entering the euro-zone;
- 2015 – target for entering the euro-zone, according to a recent position expressed by the National Bank. In this scenario, 2014 is the year when EU approves Romania's entry, to become effective since 2015.

While some barriers and departures from the mainstream objective of convergence with the EU have occurred, especially in the election years (2004 and, in particular, 2008 marked a surge in public expenditures), Romania remained committed to a policy mix which would maintain its chances to gradually adjust the economy to the point where euro adoption would become a normal evolution.

The remainder of this section provides an overview of nominal and real convergence patterns before and during the global crisis.

1. Before the global crisis

Monetary policy Monetary policy has been quite tight over the last five years, marked by high levels of minimum compulsory reserves (40% for foreign exchange) and by a prudent approach to the reference interest rate (for example, even in May 2009, the interest rate is three percentage points above the annualized inflation rate). Sterilization was frequent, as the National Bank of Romania (NBR) tried to absorb the market's excess liquidity.

Romania sustained a gradual disinflation trend until mid-2007, with a minimum level of annualized inflation rate of 3.66% reached in April 2007. This downward trend was favoured by the sharp appreciation of the local currency against the euro, especially in 2005 and 2006, in the context of the massive foreign capital inflows in the anticipation of EU accession.

However, wage and demand pressures remained strong during this period, warning of the potential for the economy to overheat. On average, in the public and private sectors together, the nominal wage increased by about 20-25% every year between 2003 and 2008, while productivity gains, at its best, never exceeded 10%. Household consumption, fuelled by a credit boom (around 60% increases every year), was the main contributor to above potential GDP growth rates.

These pressures became evident after mid-2007, when HICP inflation surged rapidly, also driven by high increases in agricultural and fuel prices and by the swift depreciation of the RON. Inflation approached 9% during 2008, to end that year slightly below 7%.

Persistent inflation has its roots in unresolved structural imbalances. In emerging economies, the structural approach works better than pure monetarism. Inflation is the result of multiple mismatches on various markets. The country, despite having one of the largest areas of agricultural cultivation of any EU member, is a large net importer of food; energy intensity is six times the EU average, and it has a growing dependence on oil and gas imports; competition enforcement is also weak, leading to high prices for most products and services.

But probably the worst disequilibrium is found in the public sector. Aggregate spending on personnel cost increased by 73% from 2005 to 2007 in nominal terms. Moreover, between 2005 and 2008 the number of state employees increased by about 15%, representing roughly one third of total employees in the country. The total public wage bill accounted for 8,4% of GDP by end of 2008, compared to 4,8% of GDP at year-end 2004. These factors pose the challenge of reconciling the inflationary effects of higher public spending with the need to consolidate disinflation.

The comparative price level is around 60% on average, but food prices are already at around 110% of EU average. In the medium term, there is further room for price hikes, mainly with respect to administered prices. A resurgence of fuel prices internationally might pose additional inflationary problems.

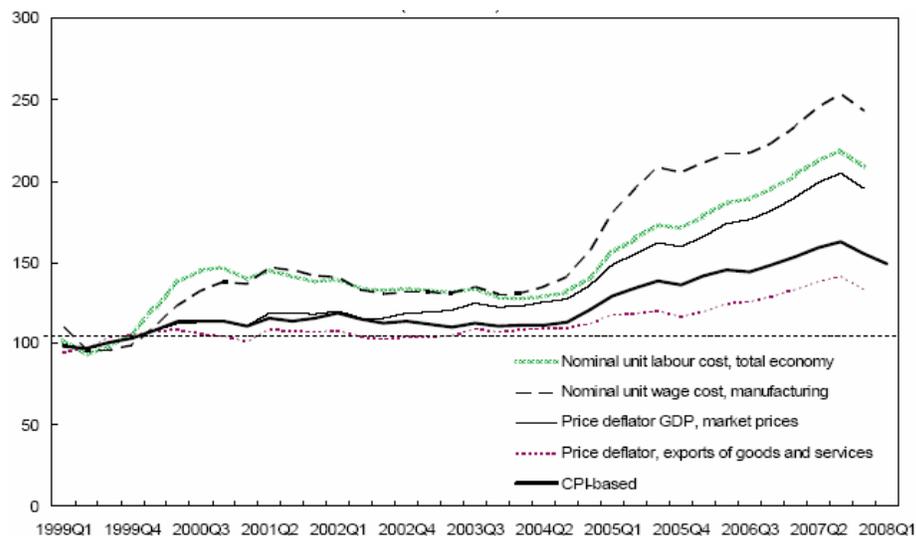
Massive capital inflows and outflows in recent years led to increased volatility of the exchange rate starting in 2004. From November 2004 to July 2007 the exchange rate appreciated from 4.2 RON/euro to 3.1 RON/euro (cca.35%). This appreciation in nominal terms, which also led to an over appreciation in real terms, was determined by the massive capital inflows (most of them speculative flows though) and by a positive market sentiment. Large currency appreciation (over-shooting) is a common effect of capital account liberalization; Romania completed its capital account liberalization, as part of the EU accession process, by late 2004 – which coincided with the start of currency appreciation. The National Bank was less prudent in this respect, and it failed to introduce measures to prevent (or tax) speculative capital inflows.

The result was an illusion of welfare and an improved standard of living; many people jumped on to borrow money in euro or even exotic foreign exchange (such as

Japanese yen, Hungarian forint or Swiss franc). This also led to a hike in real estate prices and to further foreign exchange denominated credit boom.

This illusion began to fade in the second half of 2007 (see also figure 1) and turned into a nightmare during 2008; in January 2009, the exchange rate was back at 4.2 and even 4.3 RON/euro.

Figure 1. Real effective exchange rate



Source: IMF Country Report 08/210

Regarding the average long-term interest rates in Romania, they have been above the reference value since 2006. It is impossible to conduct a pre-2006 comparison as Romania did not yet issue long-term bond yields. Even after 2006, the benchmark is difficult to set; the European Commission (EC), for example, takes a basket of three bonds with a maturity lower but close to 10 years when they estimate that the long term interest rate was around 7% between 2006-early 2008.

However, the discontinuous issuing of long term government bonds and the illiquidity of their secondary market make it hard to assess this criterion. These problems point, however, towards the lack of depth and credibility of this financial instrument, which means that Romania is not ready for this criterion. Short-term borrowing (in November 2008 Romania even had two issues of one-week maturity treasury bonds, with a yield of 14%) is rather the rule, and there will be some time before long term bonds will be available on a continuous basis for comparison.

Fiscal policy The public finance criteria was the only criteria met by Romania for a long period of time, due to the very low government debt (well below the 60% threshold), and to an improved management of the public budget. Fiscal compliance of direct taxes has been enhanced (from around 60% to over 80%), but evasion remains high on indirect taxes. While revenue collection increased in nominal terms, it failed to exceed 32% of GDP in any year. When crisis hit the country in the last quarter of 2008, the budget revenues fell even below 30% of GDP - back to the early 2000 levels in real terms.

Public spending increased substantially, from 23 bn. euro in 2005 to 44 bn. euro in 2008; a significant part of this increase is owed to the changes of pensions' indexation in relation to wages, from 31% to 43% in only 16 months (between June 2007 and November 2008).

The budget deficit has increased year after year, although it became worrisome only in 2007, when early warnings were that it may exceed 3% of GDP in 2008. This was realized; indeed, in the context of an electoral year, when revenues fell short of expectations but social expenditures were made in advance. Romania ended 2008 with a 5.2% budget deficit (4.8% on cash flows). In fact, the deficit was even higher, but due to the aforementioned potential for GDP growth, the cyclical component of the deficit outbalances part of the structural deficit. The latter was calculated at 6.6% of GDP. With recession looming in 2009, and hence a negative contribution from the cyclical component, the budget deficit could even exceed 7% of GDP in 2009 in the absence of reforms.

The budget for 2009, passed by Parliament in late February, forecasted a 2% budget deficit. This was clearly too optimistic, especially on the revenue side (which was expected to reach 33% of GDP). During negotiations for a loan from the IMF, the government accepted a larger budget deficit of 5.1% of GDP (4.6% by cash flows). This is a better solution, as it leads to a gradual approach regarding the contraction of public spending. The target for 2010 will be around 4%, with the possibility of bringing the budget deficit within the 3% framework by 2011 or 2012 the latest.

In late April 2009, the excessive deficit procedure began against Romania for the 5.2% deficit in 2008. However, if Romania fulfills the conditions agreed upon in the stand-by agreement with IMF and the EC, its budget deficit should return below to the 3% limit by 2011. An interesting detail, nevertheless, is that the agreement with IMF has not yet been made public; the public opinion is unaware of the conditionalities imposed on Romania, especially in terms of fiscal and budgetary policy.

A key problem linked to the public finance is the lack of multi-annual budget programming. The lack of such a multi-annual framework, which signals the absence of strategic planning, impedes upon the realization of public expenditures. In particular, it leads to higher than expected costs in infrastructure projects (as it was the case, for example, with the motorway built by the American company Bechtel; its cost multiplied by three times since 2003, despite the fact that not even a kilometer of the motorway has been completed). Moreover, the lack of multi-annual budget programming facilitates numerous budget revisions during the fiscal year; there were between three and five budget revisions in each of the previous five years, and one revision already in April 2009.

Another problem on the expenditures side of the budget is the parallel existence of tens of special laws for each category of state personnel (e.g. military, justice, health, education, etc); the absence of a unified law based on common principles renders it impossible to implement a coherent overall pay strategy and leads to distortions on the labour market. Among the implications of this problem are: the fact that non-wage compensation represents a disproportionate share of total compensation (around 50%); compensation decisions are discretionary; the principle of equal pay for equal work is not respected; also the principle of equal pay for equal education is not respected.

Structural factors

Labour market Despite recent years of high GDP growth, the overall employment rate in Romania has been quasi-stationary (64.6% for males, 53% for females, and 58% on average) and it remains modest relative to the Lisbon agenda target, the EU 27 average, and the best performers in the new member states (primarily Poland, Slovakia and Bulgaria). Reasons for this are the sluggish structural reforms in the public sector, the still high level of social contributions, the rigidity of the employment protection legislation, and – first and foremost – the large external migration flow.

Evidence suggests that some labour market categories have particularly low participation rates. These categories are comprised of women, older workers outside of agricultural occupations, and young people. The employment rates of these groups are significantly below the Lisbon targets. For example, women's employment rate hovered at 53% in 2006 – around 10 % points below that of males. Additionally, the employment rate of older workers is approximately 40%, well below its Lisbon target.

The introduction of provisions allowing for part-time employment in the 2003 Labor Code appears to have yielded positive results. Currently, around 10% of employment is part time, one of the highest in Central and Eastern Europe, after Lithuania and Poland, although still well below the EU 27 average and the top European performers. It is encouraging that the share of part-time employment for the 15 to 25 year old age group is significantly higher, at over 15% of the total employment for this category, particularly as this group has a low participation rate and a high unemployment.

A phenomenon which has become increasingly evident in recent years in Romania, as well as in most of the new EU member states, is the coexistence of labour and skills shortages in some sectors with excess supply in other areas of the economy. While labour participation remains low by European levels and is only slowly picking up, labour demand has expanded exponentially in recent years. This has led to important shortages of labour and skills in segments of the labour market and has exacerbated imbalances by pushing wages above productivity gains, affecting competitiveness and augmenting inflationary pressures. The situation is somewhat paradoxical, as Romania should not suffer from overall labour shortages, in spite of the large external migration flows. Inactivity rates are high, including among the young population, and there is a large under-employed pool of labour in the rural areas. With around 45% of the population living in rural zones, and a significant unemployment, with rates often in double digits, in small urban mono-industrial localities where traditional industries collapsed raises the fundamental question of why this important labour potential has not been appropriately exploited.

Evidence points toward several plausible explanations. First, it indicates a substantial mismatch between the skills of the labour released in the process of enterprise restructuring and the changes in the demand for labour. Put it simply, the large cohorts of workers who lost their jobs throughout the transition in the declining sectors have not been absorbed by the growing ones and have rather been pushed into unemployment, usually long term, into agriculture or out of the labour force. These outflows of labour, predominantly from traditional heavy industries, have been very large, as job destruction in Romania was among the most substantial in the former socialist bloc, relative to the size of its labour force.

A second explanation is associated with the relevance of education for the needs of the labour market. Labour force surveys point to an important flow of graduates, at all levels of education, going directly into unemployment and out of the labour force, including through discouragement. This suggests that there are important gaps that the current curricula fail to address in terms of endowing student with the appropriate mix of general and specific skills in order to make them attractive for employers. Further, as the number of tertiary education students coming from rural areas is almost insignificant, it suggests the existence of significant obstacles to accessing education which, inevitably, are reflected in labour market imbalances.

A third factor that explains the current widening imbalances is the low internal labour mobility, particularly between the rural areas, where the surplus of labour largely rests, and the growing urban regions, the engines of growth, where the demand for labour comes from. The complex transition Romania has gone through has seen large outflows of labour from the declining urban industries into agricultural and rural areas, while the migration from the latter to the former has been relatively modest. The situation is partly explained by the large external migration, as people appear to be better off by leaving the country and working in the old EU member states, rather than moving to the cities. While there is migration from rural to urban, the inflows do not seem sufficient enough to keep up with the increased demand. Cultural factors also seem to be at play as, traditionally, people do not move where the jobs are, a feature characteristic of much of Europe.

External migration augments the existing and widening labour market shortages. The number of Romanian workers abroad is estimated at over 2 million. The remittances these workers sent back to their families account for approximately 6 % of GDP (over Euro 6 bn.) in 2007. Romanian workers seem to be concentrated in countries like Spain and Italy that are experiencing both labour shortages and tight labour market regulations.

The large informal economic sector, estimated at 20% of GDP, may also explain the low formal employment figures and the low unemployment paradox. The grey economy appears to provide a large number of low paid jobs to mostly unskilled individuals who cannot find formal employment. Limited quality job opportunities and long unemployment spells discourage people from actively looking for jobs, and push them out of the labour force or into subsistence agriculture. The number of discouraged workers seems to be large, especially among the young.

Romanian unemployment is long term, characterized by relatively low entry and exit rates and high average durations. Over 50% of the unemployed have been in the unemployment pool for more than one year, above the EU 27 average. There is also no indication that the numbers will decline in the future, as the current levels have persisted for years. Older workers, the unskilled, those with lower levels of education and those with non-transferable specific skills are particularly affected.

While employment levels are still far from the EU average and EU Lisbon targets, labour productivity is converging rapidly towards the EU average. As a result of substantial investments, labour shedding, resources reallocation towards more productive ends, as well as to improved corporate governance and business climate, productivity in industry has been growing at around 11% y/o/y for 2006 and 2007. At the same time, real wages are expanding even faster, eroding external competitiveness and augmenting inflationary pressures. As a result, overall labour

costs almost doubled between 2005 and 2008. Nevertheless, labour costs remain substantially below the EU average.

Dynamics of competitiveness An important condition for a country's competitiveness is its capacity to attract foreign direct investment – especially in a capital-scarce post-communist economy.

Romania has been increasingly attractive for foreign direct investments (FDI), as prospects for EU membership became stronger, and were finally confirmed. While the stock of FDI between 1990-1996 was 1 bn. euro, then the average annual flow of FDI was 1 bn. euro between 1997-2002, the surge in FDI started in 2003¹. The large figure for 2006 (almost 10 bn. Euro) is explained by the high value privatization of the Romanian Commercial Bank (about 30% of the annual FDI flow).

Foreign ownership accounts now for more than 90% of total assets of the banking system, for 100% of the mobile telecommunication services, and for more than 80% of the turnover in the manufacturing industry. Studies² have found a positive correlation between foreign ownership and productivity growth in the manufacturing industry, but one must take into account the very low starting base (high reserves of X-efficiency reserves).

However, the FDI attracted so far failed yet to turn around decisively Romania's competitiveness. The main explanation lies in the preferred areas for investment: more than two thirds of total FDI flows after 2003 went into three sectors: retail, real estate and banking – all of which fuel consumption of imported goods.

The trade deficit (which is, after all, the ultimate reflection of competitiveness) has been widening every year since 2000. The export of high-tech products and services still represents a small fraction in Romania's exports (4% in 2006, compared to 3% in 1995). Foreign private debt, most of it short-term, linked to FDI, more than tripled in only three years (2005-2007), reaching more than 80% of today's total foreign debt.

The large foreign firms operating in Romania act as islands of profit, separated from the rest of the economy. They pay little profit tax (either due to case-by-case tax incentives, or due to transfer pricing), and pay small wages to the blue-collars. Competition problems are high in the Romanian economy, especially in the post-privatization cases, which affects consumers through higher prices. The privatization process has been quite controversial; anecdotal evidence suggests that from an initial number of 3600 state owned enterprises, more than 8000 were privatized (as many enterprises were divided), and about 600 were left to be privatized. Moreover, from the 8000 privatizations, about half of them went to court, challenged by one of the sides. The most widely used method of privatization was direct negotiations, which led to market power inducements for the buyers. The most contested privatization was that of Petrom (the state oil and gas producer) in 2004; the price paid by OMV to buy the majority stake is equivalent with one year's profits of Petrom (after privatization), while the Romanian state lost access to resources. Many of privatizations cannot even be classified as „privatizations“, as they were merely a transfer from one state

¹ Arguably, part of this has a statistical explanation, as reinvested profits were included in the calculation of FDI only starting from 2003

² Voinea, L. (2006), „As Good As It Gets? FDI Dynamics and Impact in Romania“, in *Foreign Direct Investment Policies in South-East Europe* (eds: R.Jovancevic, Z.Sevic), Greenwich University Press

ownership to another state ownership: OTE (telecommunications), Gaz de France (utilities), OMV, and many other foreign buyers are in fact state-owned. Nevertheless, one should be honest and acknowledge that some large privatizations proved to be successful, most notably Dacia-Renault (1998) and Sidex-Mittal Steel (2001). Even in these cases massive state aid was granted, but the dynamics of the privatized companies were very positive, making them the leading Romanian exporters. The reason for this was that the foreign investors in those cases were large multinationals, which integrated the acquired companies into their global production and distribution networks.

Multinationals like Nokia and Ford recently started their new production facilities in Romania. Rumours are that other multinationals, especially in the car industry, are planning similar moves. In fact, Romania has become a regional hub for car makers and car components producers. Romania has also had a tradition, which it managed to keep alive, in building ships and aircraft components. But many of these producers are relocating, or are planning to relocate. This, in my opinion, is an advantage that will fade. A March 2008 strike at Dacia-Renault emphasized this issue. Romania will no longer be, in the medium term, an equivalent of China within the EU as a source of cheap labour. The nature of Romania's competitive advantage is changing, as the economy as a whole is shifting from a factor-based economy to an investment-driven economy. Eventually, Romania should move towards an innovation-driven economy; this is a lengthy process, as structural imbalances are still significant, but it is worth looking at the current state of the national innovation system.

Investing in education and research is a factor that could help Romania in catching up with the EU average. On the one hand, investment in education and research can lead to the creation of value-added local products and services, and can contribute to lowering the trade deficit. On the other hand, access to education and knowledge can stimulate the saving and investment behaviour (as opposed to consumerism) and serve to raise labour force mobility within Romania. Consequently, Romania increased its public spending on R&D from 0.2% of GDP early in this decade to 0.5% of GDP in 2008. While the Lisbon target of 1% of GDP by 2010 was accepted by all political parties in a national pact on education signed in 2008, the budget constraints in 2009 led to a severe cut in public expenditures for R&D, back to 0.19% of GDP.

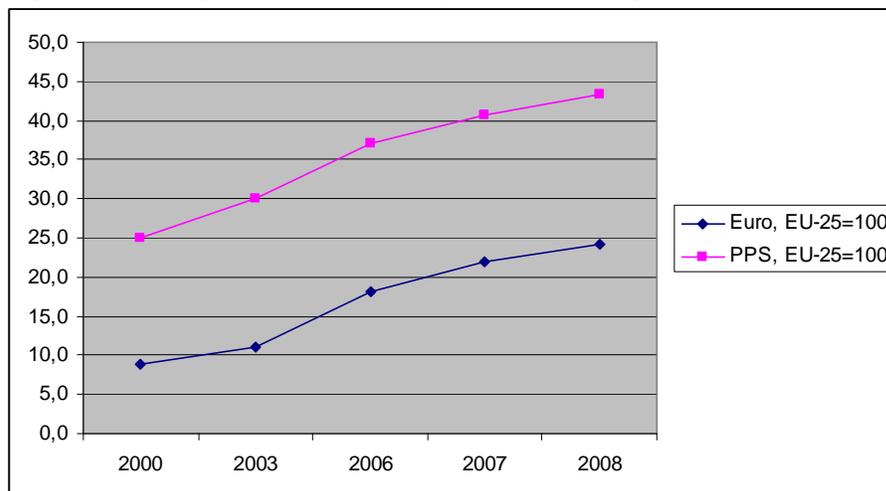
However, spending public money is not all it takes to enhance research and development (R&D) and innovation. How the money spent is equally important. Romania has a poor record on the efficiency and effectiveness of public R&D expenditures. First, public spending fails to attract private spending; there is little, if any, spreading-out effect – as it should be. The private R&D expenditures have been stagnant at around 0.2% of GDP, despite a five time increase in public spending. This shows that the allocation of money does not stimulate private R&D. Second, more money is given for fundamental research than for applied research; industrial research consistently dropped as a share in public spending for R&D. This situation will not stimulate cooperation among universities and industry. Third, the design of the national innovation system is inefficient. A number of problems can be identified in this regard: the uncertain role and poor efficiency of the national research institutes; the low university-industry link; the overlaps between various agencies and ministries with a role in administering the national innovation system; the lack of an independent national research council; the lack of a state (co)funded venture capital fund for innovative small and medium enterprises (SMEs); the lack of ex-post evaluations for financed programmes and the lack of impact analysis.

Another aspect of long-term competitiveness of the Romanian economy pertains to the absorption and use of EU structural funds. There are structural operational programmes designed for competitiveness, infrastructure and transport, environment, human resources, and regional development. The EU will allocate about 19 bn. euro to Romania until 2013 for these objectives; while this may seem like a large sum for the Romanian economy, it is in fact lower than the amounts committed to Hungary or the Czech Republic (countries with a much smaller population than Romania). However, the absorption rate was very low in 2007 and 2008 (around 5%); among the causes for that, are the bureaucratic mechanism and the lack of co-financing from the potential beneficiaries. In this context, it is of paramount importance that the EU budget and review for the financial perspective 2014-2020³; in particular, Romania would be very hard hit from a severe cut in agricultural subsidies, as one third of EU's farmers live in Romania.

Catching up in GDP levels

Romania caught up very fast with the EU-25's GDP both in euro and at PPS (see figure 2). In fact, the devil is in details. First, the Bucharest region is like a separate economy from the rest of the country, which is comprised of eight development regions. While the average GDP/inhabitant at PPS is 43%, the Bucharest region is at 62% of EU average. The second most developed region (in the west of the country) is at 33%, and the poorest region (the north-east) is at 21%.

Figure 2. GDP per inhabitant, % of EU-25 average



Source: the author, based on Eurostat

Regarding the composition of GDP, the high rates of growth between 2002 and 2008 were driven by the construction sector (an average growth of 25-30% every year), on the one hand, and by household consumption fuelled by loans, on the other.

³ See Daianu, D. and C.Pauna, A.Ujupan, L.Voinea (2008), *Managing diversity for a growing Europe: a Romanian perspective on the EU budgetary review process*, paper presented to the European Commission in the public consultations process, available at http://ec.europa.eu/budget/reform/index_en.htm

These sectors are highly volatile and, as the crisis struck the country particularly hard in the first quarter 2009, these sectors were most affected. Catching-up may prove without a solid base, and Romania might stop its real convergence process for a couple of years as a result of the crisis.

2. The impact of the global crisis

Monetary and fiscal policy The National Bank will gradually reduce the reference interest rate, to help commercial banks fuel credit activity once again. However, some financial indicators are worsening for the local banking system. The two most worrying indicators are the ratio of loans to total assets, which reached 62% by end of Q1 2009, which signals an underperforming credit system; and the ratio of bad loans to total loans, which has seen an upward trend since the beginning of the crisis and it is likely to further increase as unpaid debts exceed 90 days, reaching the point where they must be declared bad loans and provisioned in the books. The consequences are that the credit activity will not restart until banks increase their assets and bad debtors help to overcome the difficulties.

Regarding inflation, two important contradictory factors will play a role in taming inflation and inflation expectations in the near future. On the one hand, the decrease in domestic consumption (which occurs by default, as unemployment grows and access to financing grows increasingly difficult) and the cap on government consumption (which is part of the IMF agreement) may help the disinflation process; a very severe consumption contraction could even spur deflation expectation. On the other hand, the weakening of the RON, partly determined by the National Bank's need to cut the reference interest rate in order to increase liquidity, would contribute to imported inflation; apart from imported goods (energy and food mainly), many local services are priced in euro (e.g. telecommunications, cable).

Regarding the exchange rate, the IMF loan will probably calm down markets for a while, but the currency will not be able to outperform the economy. Conservative forecasts estimate a slower depreciation of the RON in 2009 and even in 2010. While swings are possible, the existence of the IMF safety net may prevent speculation, and therefore the volatility of the exchange rate might be reduced over the next two years.

The crisis is also an opportunity in disguise to discipline Romania's public finances and to finally make long-postponed structural reforms. The first step was made by concluding a stand-by agreement with IMF for a 19.95 bn. euro loan over two years. The first part of the loan was received in May. Most of it (12,95 bn. euro) will go to supplement the foreign exchange reserves of the National Bank, while the rest – coming from the EU, World Bank, EBRD and EIB – will help finance the budget deficit.

Regarding the government debt criteria, the very large loan from the IMF (20 bn.euro, representing cca.15% of Romania's GDP) will pose serious challenges to the capacity to take further loans after 2011. In addition, the government plans to issue state guarantees for private debts of 1.5 bn. euro in 2009. One should also be aware of the fact that 2009 is also an electoral year (elections for the European Parliament are scheduled for June and for the Presidency in November), the IMF agreement may not be sufficient to cut public spending; some structural fiscal and budgetary reforms may be postponed until 2010.

Structural factors Much depends on the government's understanding, ability and willingness to implement reforms without creating more losers in the midst of a turbulent economic period.

The rationale for economic reform rests on three requirements, as the World Bank mentioned in a report for the use of the Romanian Government⁴: fiscal savings, de-leveraging (diversification of the sources of growth), and social cohesion and equality.

There can be no recovery and no sustainable growth without investment, and the financing of investment can no longer rely exclusively on external savings. Indeed, domestic savings rates were 13% of GDP, almost half the EU average. Fiscal savings mean that reforms are needed in the area of public financial management, public administration, macroeconomic management, and efficiency of public spending. However, the government should be careful not to repeat the same type of mistakes of the former government; it should henceforth avoid pro-cyclical measures which would translate into more taxes in bad economic times.

Diversification of the sources of growth is needed, as the model of the past years - based on pro-cyclical fiscal policies, the real estate boom and increased consumption - has been exhausted. Romania needs to unlock its business potential, stimulate the private initiative, and facilitate research, development and innovation in line with the Lisbon Agenda goals. Romania also needs to invest more in transportation and energy infrastructure, and reform agriculture.

Structural reforms should also be enforced in sensitive sectors such as energy and agriculture, while R&D should be promoted. In the energy sector, it is important for Romania to build new transportation infrastructure (the much awaited Nabucco gas conduct), and to reach a new deal with Russia for lower prices on gas imports (currently, Romania pays the highest price for gas imports of all EU members). In agriculture, it is important to fight for keeping EU subsidies for small farmers, and to gradually shift the focus toward rural development (which includes other services and activities aside from agriculture). Regarding R&D, public expenditures need to be better allocated, an ex-post evaluation mechanism has to be implemented, and the governance structure of the national innovation system needs to be improved.

Another big structural problem that requires attention is the mismatch between the labour market and education. Education should be better suited, through various incentives and performance-related measures, to equip young generations with the skills required by the labour market. Moreover, expanding the use of life-long learning opportunities should better linked to the provision of skills to the fast changing sectoral and occupational profile of the demand for labour. Labour policy reforms have to focus on bringing back into employment those labour categories that are unable to take advantage of growth, as well as on reducing the transaction costs for companies. Youth, older workers, women and the long-term unemployed are particularly affected by high unemployment and/or underemployment.

This brings us to the major issue of protecting the less favoured social groups, and primarily the poor, as any crisis boosts poverty and could undermine social cohesion.

⁴ World Bank (2009), *Romania: Policy Briefs for the Government of Romania*, Europe and Central Asia Region

Economic reforms must be accompanied by social policies that ensure equity by providing access to employment, public services, and targeted social assistance.

III. International and policy environment regarding the Euro adoption

1. Before the global crisis

In terms of legal compatibility, the EC⁵ emphasizes that there are a number of incompatibilities between the Law 312/2004 on the Statute of the National Bank and the provisions of articles 108 and 109 of the EC Treaty and the European Central Bank (ECB) Statute. These incompatibilities refer to the objectives of the ECB (institutional and personal independence), the ECB's right to be consulted in its fields of competence (the promotion of smooth operation of payment systems), the statistical role of ECB and of the EU Council, and their roles in the appointment of an external auditor. Nevertheless, these problems can be dealt with and they will not constitute a decisive barrier to Romania's accession to the euro-zone.

There is a political consensus regarding joining the euro-zone. The National Bank, the Ministry of Finance, the Prime-Minister and all the political parties represented in the Parliament all agree on this issue. A somehow separate opinion was expressed by the President, last autumn, in the context of discussion regarding a supervising mechanism for banks in EU, when he said that Romania does not need the EU supervision mechanism in the banking sector. This was a single statement rather than a policy orientation, and there are no reasons to believe that the President or anyone else in the political area would oppose the euro-accession.

Two factors are important from a political point of view. First, there are few, if any, emotional factors linked to the replacement of the RON by the euro. Quite the opposite, Romania has a *de facto* Euroization of some parts of its economy, as more than half of loans are denominated in euro, wages are often negotiated and set in euro, real estate prices are set in euro, and many private services and even public utilities have their tariffs related to the euro. Second, since there is a consensus on the topic, and few emotions are involved, the topic of entering the euro area is not of electoral interest for politicians. The opportunity of entering the euro area and the steps toward it has not been a topic in the voting campaigns for the European Parliament (November 2007 and June 2009). Of course, this was also not a topic in the domestic electoral campaigns.

The target date of 2014, however, remains indicative; while the new government wanted to emphasize the need to adopt the euro by 2014, as an explicit objective, the events show how difficult it is to make predictions in emerging economies.

The policies implemented by the IMF loan will introduce more discipline in the public finance and will enforce some structural reforms, therefore paving the way for euro adoption. Yet, adoption of the euro should not become a fetish. Romania should not try to become a euro area member before it is fully prepared to do so. Otherwise, there will be major social costs in the short and medium term and a major loss of competitiveness in the medium and long run.

⁵ European Commission (2008), *Convergence Report 2008*, DG Economic and Financial Affairs

2. The impact of the global crisis

The global economic crisis leaves economies like Romania open to speculative attacks and sudden depreciations of the local currency. One could also find a good side to this situation: the proven similarity of business cycles between Romania and the EU, which had not been proven before, although it was tested in 1997-1998. The adoption of the euro would represent an anchor of stability against such attacks.

Under pressure from the global financial crisis, two opposing opinions were stressed in the international media and in political and economic circles with regard to the prospects of euro-accession for countries like Romania. One view is to expedite the process of entering the euro area, either by loosening the Maastricht criteria or by a unilateral adoption of euro. The opposing view is to postpone joining the euro area because the crisis has proven that countries like Romania are far from being ready to take such a big step forward. Both views have their merits, but it is more important, in the context of this paper, to see how the Romanian officials react to them.

The NBR, by voice of its Vice-Governor, recently (April 2009)⁶ expressed its view with regard to possible strategies for euro adoption in Romania. His opinions are summarized below.

The first scenario, to hasten euro adoption in the short term, has the following advantages:

- the exchange rate risk disappears faster, which could contribute to sustainable economic growth;
- reduced incentives for not undertaking structural reforms;
- stimulating the coherence of the policy mix

and the following disadvantages:

- losing monetary policy and exchange rate autonomy, which would put great competitiveness pressures on the economy;
- increased risk of asymmetric shocks;
- difficulty to find the appropriate reference exchange rate;
- higher probability for a more intense and rapid Balassa-Samuelson effect, leading to higher inflation;
- limit the time to test the efficiency of the inflation target mechanism;

The second scenario, to postpone euro adoption in the long run, has the following advantages:

- more time to implement structural reforms;
- more time to make progress in terms of nominal and real convergence;
- lower risk of asymmetric shocks;
- more time for monetary policy and exchange rate policy autonomy

and the following disadvantages:

- persistent higher transaction costs, which could affect investments and economic growth;
- higher risk of postponing structural reforms and of relaxing the policy mix (the fiscal stance and the wage policy);
- unclear messages sent to international financial markets (postponement could be attributed to deeper imbalances in the economy rather than to authorities' decision).

⁶ Cristian Popa (2009), "The unilateral euro adoption, a solution or a trap?", presentation at the Monetary Policy Debates, National Bank of Romania, April 30, 2009.

I personally agree with most of these arguments, except maybe with the one referring to the time needed to prove the efficiency of the inflation target mechanism. In my opinion, inflation targeting has not been an efficient monetary policy, as the NBR failed to reach its target (even with a large +/-1% margin) in three of the last four years since it has been implemented.

Between the two more extreme choices, of either hastening or postponing euro adoption in Romania, the balanced and more desirable option, according to the NBR, is to enter the ERMII in 2012. This option would combine the advantages of the more extreme alternatives, while limiting their disadvantages. Entering the ERMII in 2012 would secure a reasonable adjustment period for:

- completing most of the structural reforms needed and for increasing the flexibility of the labour market;
- gradually implement the disinflation process;
- leaving behind the peak in foreign capital inflows;
- synchronizing business cycles;
- creating the *ex ante* conditions for staying only two years in the ERMII.

Conclusion: progress, perspectives, recommendations

Romania currently fulfills two of the five Maastricht criteria: public debt and exchange rate volatility. Inflation has always been out of target; more recently, another major problem appeared as the budget deficit was over 5% of GDP in 2008. As prospects are not encouraging regarding the fast cut of the deficit, which would also not be recommendable in times of crisis, the EC launched an excessive deficit procedure against Romania. These two criteria, inflation and budget deficit, are the main obstacles to euro adoption in Romania from the nominal convergence point of view. Other real convergence indicators show that Romania still needs to perform a number of structural reforms in order to be prepared to join the euro area.

The sharp adjustment in the current account deficit, which started in early 2009, and the current stagnation of the non-governmental credit, both could help to keep the adjustment period within the medium term (three years), therefore supporting Romania's ERMI accession in 2012. This is currently the working scenario and *ceteris paribus*. It is also the most likely scenario, in my view.

However, this does not mean that Romania and other countries in the region should adopt the euro ahead of time, but that more reforms are needed urgently.

A number of issues regarding the euro itself and the adoption of euro in countries like Romania may give us food for thought:

- It is possible that, by the time Romania joins the euro-zone, the euro would have lost the fight with other currencies.
- As ten EU members are currently in the excessive deficit procedure, it is possible to see a relaxation of the deficit criteria for euro adoption in the medium term. Otherwise, one should not rule out the possibility that one or more euro area members face an exit mechanism from the euro area, which would destabilize the entire euro concept and framework.
- The large waves of Romanian migrants in Europe may make the convergence indicators less relevant, as convergence may happen individually rather than collectively (individuals working abroad already converged to euro area indicators).
- The dominance of foreign capital in Romania (more than 90% of total assets in the banking system, and more than 80% of turnover in industry and services) creates similarities in the business cycles in Romania and in the euro area and limit the impact of national monetary policies.
- The euro is a *de facto* currency for an important part of the Romanian economy, as 60% of total loans are euro-denominated; furthermore, real estate prices and most wages in the private sector are set in euro.

Under all these circumstances, Euro adoption is neither the main nor the most urgent task Romania has at hand. It is not a universal panacea, at least not for Romania's structural reforms. It should not be the ultimate goal, but a normal result of undertaking the necessary fiscal and structural reforms. How long the process takes is less important than to get it right.

Appendix

Yearly data, 1999-2008 (for countries that joined EU in 2004); 2002-2008 (for countries that joined EU in 2007)

	2002	2003	2004	2005	2006	2007	2008
HICP (EU harmonized inflation index)	22.5	15.3	11.9	9.1	6.6	4.9	7.9
Budget deficit/surplus - % of GDP (General Government Budget Balance)	-2	-1.5	-1.2	-1.7	-1.9	-2.7	-5.2
General Government Gross debt, % of GDP	25	21.5	18.8	15.8	12.4	13	11.7
Long-term interest rates (10-year government bonds) – end of year							
Exchange rate - % change against the Euro	-20	-20.1	7.9	10.6	7.1	-6.8	-10.2
Price level compared to the EU average (Eurostat)	43	43.4	43.3	54.3	57.1	61.5	
GDP per capita at PPS as % of EU average (Eurostat)	29.4	31.3	34.1	35	38.3	42.1	44.8
GDP growth	5.1	5.2	8.5	4.2	7.9	6.0	7.1
Employment rate (15-64)	58	57.8	57.9	57.7	58.8	58.8	58.3
Export growth	21.80%	6.40%	21.30%	17.50%	16.20%	13.70%	13.80%
Current account - % of GDP	-3.3	-5.8	-8.4	-8.9	-10.4	-14.1	-13.0
FDI - % of GDP (+ % of FDI coming from EU countries, if data exist)	2.5	3.6	8.4	6.6	9.0	6.2	5.0
FDI from EU countries - % of GDP							
External debt (private + public) - % of GDP (+ net external debt, if data exist)	37.5	37.2	34.7	39.7	40.3	52.1	55.4
Trade with EU countries, % of total - EXPORT	67.1%	67.7%	72.9%	67.6%	67.70%	72.00%	70.50%
IMPORT							
Bank credit growth (% change)	58.3	70	51.1	29.1	54.5	60.4	33.7
M2 (% change)							
Interbank interest rates, monthly averages for the corresponding year	20.4	18.8	17	9.7	7.4	7.9	13.9

Share of deposits and credits denominated in Euro	41	40	35	33.7	32.3	32	34.7
EU banks ownership of local banks, % of total assets	56.4	58.2	62.1	62.2	88.6	87.8	88
Stock market index	119.8	30.9	100.9	50.9	22.2	22	-70.4
World bank doing business ranking					n.a.	47	47

Monthly (starting from June 2008) and quarterly (starting from IQ 2008) data. According to the frequency (monthly; quarterly) of their issue

2008	Q1	Q2	Q3	Q4	2009 Q1				
	June	July	August	Sept.	October	Nov.	Dec.	January	February
GDP growth, % change from the same quarter of the previous year	8.2	9.3	8.9	2.9	-6.4				
Industrial production, % change from the same period of the previous year	4	5.1	-1.5	3.8	-3	-11.5	-18	-12.1	-12
Unemployment rate	3.8	3.8	3.8	3.9	4.0	4.1	4.4	4.9	5.3
HICP (EU harmonized inflation index), % change from the same month of the previous year	7.1	7.6	7.8	7.9	7.9	7.9	7.9	7.9	7.8
Exchange rate - % change against the Euro, monthly	0.1	2.1	1.5	-7.7	-10.5	-3.2	-5.4	-7.3	-0.3
Government debt - % of GDP			11.6	9.3					
Long-term interest rates (10-year government bonds)									
Export growth - monthly data compared to the same period of the previous year	21.2%	20.8%	13.6%	16.60%	13.30%	-9.00%	-16.00%	-24.3	-27.7
Current account - % change yearly	-23.90%	-17.30%	-7.10%	-20.40%	-3.10%	-10.20%	-6.20%	45.30%	

FDI - % change compared to the same month of the previous year	16%	15%	13%	8%	10%	7%	7%	29%	
External debt (government + private) - % of GDP			51.3	55.4					
Bank credit growth, % change from the same period of the previous year	3.6	0.3	2.8	5.6	-0.6	1	1.5	4.1	0
M2, % change from the same period of the previous year									
Interbank interest rates	10.41	10.7	12.63	12.75	22.98	15.95	13.9	14.66	15.33
Stock market index	-17.3	-2.5	-25.7	2.9	-31.4	0.7	-6.4	-16	-27.7