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Analysis of the Convergence Criteria in Romania for Adopting the Single Currency and the Convergence Programme 2016 -2019 regarding the Monetary Policy and the Exchange Rate

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Abstract *Before a Member State can adopt the euro, it must fulfil certain economic and legal criteria. The economic convergence criteria are designed to ensure that a Member State's economy is sufficiently prepared for adopting the single currency and can integrate easily into the monetary regime of the euro area. Replacement of national currencies with the euro is a complex operation requiring numerous practical training – for example to provide guarantees that the national currency is withdrawn quickly, that prices of goods are properly converted and presented and that the population is well informed. All these preparations are based on a certain "scenario of transition to the single currency" adopted by the candidate country to the euro zone. Through this article we wanted to present an analysis of the convergence economic indicators of Romania and some countries of the European Union, based on data extracted from the Convergence Report in June 2016 and we presented the convergence program in 2016 -2019 regarding the monetary policy and the exchange rate.*

Key words Convergence Criteria, Nominal Convergence, Real Convergence, Convergence Economic Indicators, Convergence Program, Monetary policy

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1. Introduction

The convergence criteria represent the economic test for assessing of the state of preparedness of the economy to participate in the third stage of the Economic and Monetary Union (EMU).

These criteria were established by the Maastricht Treaty, ratified by all EU member states in 1993, which provides as necessary and sufficient conditions for a country to adopt the euro, fulfilment the *nominal convergence criteria*, as the price stability, public finances, interest rates, exchange rate stability and the *real convergence criteria* (referring to a series of structural indicators that concern the following areas: general economic framework, employment, innovation and research, economic reform, social cohesion and environment. The real convergence is as important as the nominal convergence, whereas according to the Optimal Currency Area Theory, the states of a group can win each other of possession of a common currency only when economic structures are similar if not the risk that asymmetric shocks hitting only some of these countries.

Optimal currency area is an economic area in which the following conditions are met:
- A high degree of economic openness for the community trade;
- A high degree of cross-border mobility of the capital and the labour force;
- High flexibility in prices and salaries;
- Fiscal transfers while the tax revenues are redistributed to the areas in recession.

Consequently, the single monetary policy aims at a supposedly homogenous group of economies and not the specifics of each economy in part.

In this context, the countries of Central and Eastern Europe cannot renounce at its own monetary policy as long as there is the risk of developing the asymmetric shocks (caused by the different structure of *the economy) is high. That happened because the ultimate aim is not only adopting the European single currency, but also to gain benefits by this option.*

2. Literature review

Mugur Isarescu in his specialty literature "*Nominal convergence versus real convergence*" (2015) believes that entering in the euro zone represents a fundamental change in the *modus operandi* for an economy that now has flexible exchange rate and independent monetary policy. Success in the euro area requires comprehensive structural reforms that will bring in the economy, sufficient flexibility of the goods market and the factors of production to offset the loss of the adjuster represented by the exchange rate and to ensure the sustainability of nominal convergence by eliminating sources of repressed inflation (for example the full liberalization of the energy market) and by the quasi-fiscal deficits (restructuring of the public enterprises with substantial losses).

In the pre-crisis period, the predominant idea was that the fulfilment of the nominal criteria was sufficiently to demonstrate eligibility/compatibility with the euro area. Some economists have debated an overly strict nominal criteria and the conflict between their fulfilling and the real convergence (Buitter and Grafe, 2002; Szapáry, 2001; Kopits, 1999; Rostowski, 2002).

3. Analysis of convergence economic indicators in some EU countries

Convergence Report of the European Central Bank in June 2016 shows the level of economic convergence which is shown in the table below:

Table 1. Synoptic table of the convergence economic indicators

	Price stability	Budgetary developments and projections of the general government			Exchange rate		Long-term interest rate	
	HICP inflation	Country in excessive deficit	Surplus (+)/ deficit (-) of the general consolidated budget	Public debt			Currency participating in ERM II 3	The exchange rate against the euro 3
Bulgaria								
2014	-1.6	No	-5.4	27.0	No	0.0	3.3	
2015	-1.1	No	-2.1	26.7	No	0.0	2.5	
2016	-1.0	No	-2.0	28.1	No	0.0	2.5	
Czech								
Republic	0.4	No	-1.9	42.7	No	-6.0	1.6	
2014	0.3	No	-0.4	41.1	No	0.9	0.6	
2015	0.4	No	-0.7	41.3	No	0.9	0.6	
2016								
Hungary								
2014	0.0	No	-2.3	76.2	No	-4.0	4.8	
2015	0.1	No	-2.0	75.3	No	-0.4	3.4	
2016	0.4	No	-2.0	74.3	No	-0.7	3.4	
Poland								
2014	0.1	Yes	-3.3	50.5	No	0.3	3.5	
2015	-0.7	No	-2.6	51.3	No	0.0	2.7	
2016	-0.5	No	-2.6	52.0	No	-4.2	2.9	
Romania								
2014	1.4	No	-0.9	39.8	No	-0.6	4.5	
2015	-0.4	No	-0.7	38.4	No	0.0	3.5	
2016	-1.3	No	-2.8	38.7	No	-1.0	3.6	

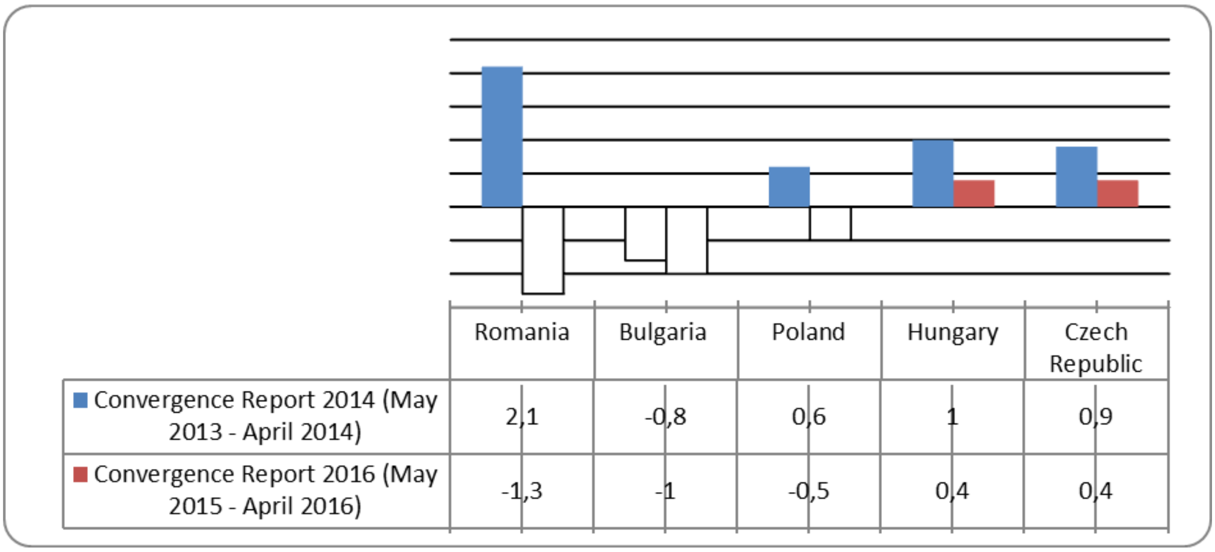
Source: Convergence Report, June 2016, www.ecb.europa.eu

All countries have recorded progress in reducing the fiscal imbalances. None of the analysed countries in this report not participating in ERM II and the currencies of some of them have recorded the large swings against the euro over the past few years. Significant progress has been realised in reducing the differential of the long-term interest rate versus the euro area.

Economic activity began to recover in the most EU Member States and the progress was gradually broadened in the analysed countries in this report. This reflects the impact of higher real disposable income in the absence of inflationary pressures in most countries, of the accommodative monetary policies and of the more obvious signals of economic stabilization in many euro zone countries. The incipient recovery determined the significant improvement of the conditions in the labour market in almost all analysed countries.

All countries have continued to record progress in correcting the external imbalances and in reducing the dependence on the external financing, particularly in the banking sector, which increased shock resistance of the most analysed countries during the recent episodes of turmoil manifested in emerging markets outside the EU. However, nationally significant vulnerabilities remain, which, if there are not properly addressed, may limit the process of long-term convergence.

Regarding the *price stability criterion*, the average annual inflation rate was lower - in some cases much lower - benchmark of 0.7% in four of the five analysed countries in this report (*Chart 1*). Bulgaria, Poland and Romania have recorded negative inflation rates. In the Convergence Report in 2014, Romania was the only country with an inflation rate above the reference value of 1.7% applicable at that time. During this time, the average rate of HICP inflation in Bulgaria, Hungary and Romania has exceeded 3%. In the Czech Republic and Poland, the average inflation rate was closer to 2%.



	Romania	Bulgaria	Poland	Hungary	Czech Republic
Convergence Report 2014 (May 2013 - April 2014)	2,1	-0,8	0,6	1	0,9
Convergence Report 2016 (May 2015 - April 2016)	-1,3	-1	-0,5	0,4	0,4

Source: Own processing data published in the Convergence Report, June 2016, www.ecb.europa.eu

Chart 1. HICP inflation (average annual percentage changes)

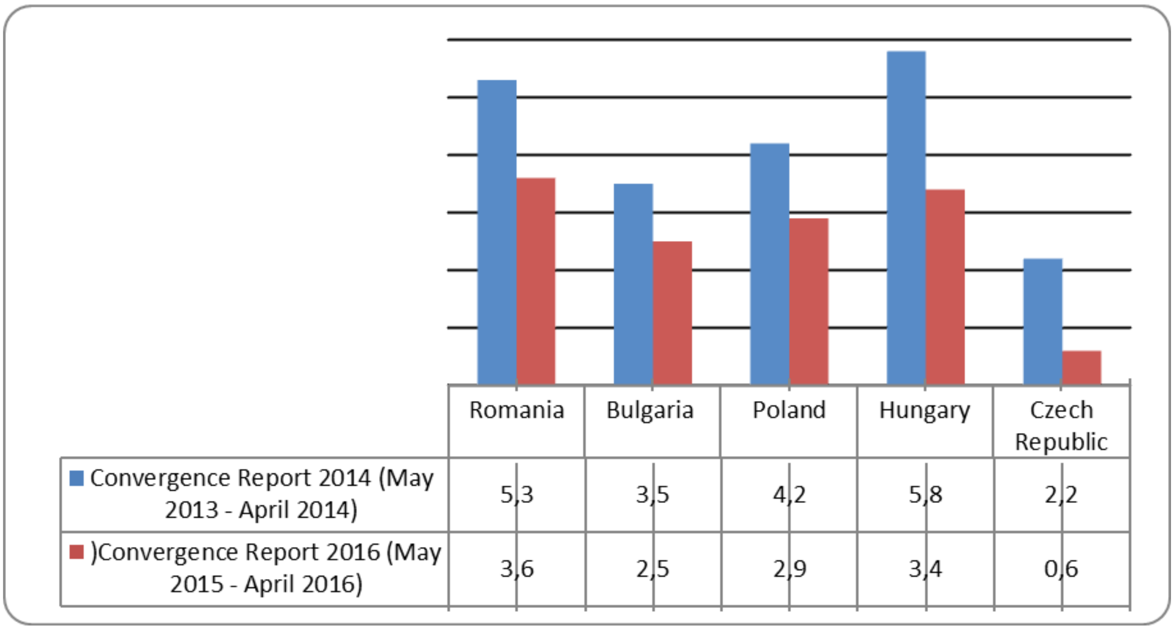
Regarding the fiscal criteria, between the analysed countries, the Czech Republic and Poland were, in turn, subject to the excessive deficit procedure. Those procedures were repealed in June 2014 in the Czech Republic and in June 2015 in Poland. In 2015, the general government balance was less or equal to the reference value of 3% of GDP in all countries, as opposed to the previous report, according to which Poland has recorded a share of budget deficit to GDP higher than the reference value of 3% in 2013.

Similar to the Convergence Report 2014, Hungary was in 2015, the only country with a share of public debt to GDP higher than the reference value of 60%.

As regards the *exchange rate criterion, none of the currencies of the analysed countries participate in ERM II.* In several countries, the exchange rate recorded a relatively high degree of volatility in the reference period of two years, except Bulgaria, whose currency is anchored to the euro under a currency board. Most of other currencies, particularly the Polish zloty was depreciated against the euro during the reporting period. In contrast, the Czech koruna was appreciated marginally against the euro.

Convergence criterion on the long-term interest rates

All five of analysed countries recorded levels below the reference value of 4%. The lowest interest rates were registered in the Czech Republic *(Chart 2).*



	Romania	Bulgaria	Poland	Hungary	Czech Republic
Convergence Report 2014 (May 2013 - April 2014)	5,3	3,5	4,2	5,8	2,2
)Convergence Report 2016 (May 2015 - April 2016)	3,6	2,5	2,9	3,4	0,6

Source: Own processing data published in the Convergence Report, June 2016, www.ecb.europa.eu

Chart 2. Long-term interest rates (average annual percentages)

From the perspective of fulfilling the convergence criteria, the sustainability is a key factor. Convergence must be achieved in a sustainable manner and not just at one point in time.

Even if the convergence criteria values are reached at one time, there is not a guarantee of the positive developments once the country becomes a member of the euro area. Thus, the countries acceding to the euro area should demonstrate the sustainability of the convergence process that they are undergoing as well as their own ability to respect the permanent commitments imposed by the euro. This serves the interest of that respective country but and the interest of the euro area as a whole.

In many of the analyzed countries there are necessary the sustainable policy adjustments to achieve the sustainable convergence. Macroeconomic stability and, in particular, a solid fiscal policy is a prerequisite condition for achieving the sustainable convergence. The high flexibility degree of the market for goods and services and the labour market is essential to face the macroeconomic shocks. There must be a culture of the stability and the inflation expectations well anchored to help for creating a stability context of the price. Favourable conditions are needed for efficient use of the capital and the labour force in the economy in order to increase the total productivity of the factors and boosting the economic growth in the long term. Also, the sustainable convergence requires strong institutions and a favourable business environment. A high degree of economic integration in the euro area is vital for synchronizing the economic cycles. At the same time, the appropriate macro-prudential policies should be implemented to prevent the accumulation of the macroeconomic imbalances such as excessive growth of the asset price and the boom and bust cycle of the credit. In addition, it is necessary to implement a suitable framework for supervising the financial institutions.

4. Analysing the convergence criteria in Romania

In April 2016, the average annual rate of the HICP inflation recorded in Romania was -1.3%, a level below the reference value of 0.7% for the criterion on the price stability. In the past 10 years, this indicator has fluctuated within a relatively wide range between -1.3% and 8.5%, while the average for the period was located at a high level, respectively 4.5%. Looking ahead, there are concerns regarding the sustainability of the inflation convergence in Romania, over the longer term. It is probable that the process of recovery the gaps to lead at the differential of the positive inflation against the euro area. To avoid the accumulation of the excessive pressure on the prices and the emerging of some macroeconomic imbalances, the process of recovery the gaps must be supported by the appropriate policies.

In Romania, the budget deficit and the public debt were within the levels stipulated by the Maastricht criteria in 2015. Romania is the subject of the preventive part of the Stability and Growth Pact, since 2013. The European Commission's economic forecast in the spring of 2016 revealed that Romania has achieved its medium-term budget objective from 2013, but with at risk of the significant deviation from it, both in 2016 and 2017. At the same time, it is estimated that the implementation measures for the announced fiscal relaxation will lead to exceed the ceiling of 3% of GDP in 2017, applicable to the budget deficit and placing the public debt on an upward trend. The Fiscal Sustainability Report published by the European Commission in 2015 highlights the high risks in the medium term to the sustainability and the long-term medium risks, partly associated with the increased spending in the health area and long-term care. Further, there are necessary reforms in these areas and a prudent fiscal policy to determine the quick implementation of the medium-term objective to ensure the sustainable of the public finances.

In the reference period of the two years between May 19, 2014 and May 18, 2016, the Romanian leu did not participate in ERM II, but also it has been traded under the conditions of the flexible exchange rate regime with the controlled floating. The exchange rate of the Romanian leu against the euro showed on average a relatively high degree of volatility in the reference period. On 18 May 2016 the exchange rate was 4.4990 lei to one euro, respectively 1.7% more depreciated against the average level of May 2014. The cumulative balance of the current account and the capital of Romania knew a substantial improvement over the last 10 years, but the amount of the net foreign liabilities, though it was gradually narrowed, remain at high levels.

In the reference period May 2015 to April 2016 the long-term interest rates were, on average, 3.6% lower than the reference value of 4.0% for the convergence criterion on the interest rates. In Romania, the long-term interest rates were placed on a declining trend since 2009, the 12-month average rates falling from about 10% to a level of below 4%.

Creating a favourable environment to the sustainable convergence in Romania requires the economic policies oriented to the stability and the comprehensive structural reforms. Regarding the macroeconomic imbalances, the European Commission has selected Romania to make depth analysis in the Alert Mechanism Report for 2016 and concluded that it does not face with the macroeconomic imbalances.

However, in many areas, there are necessary measures for improving the business and institutional environment, increasing the investment and the competition in the markets for goods and services, reducing the youth unemployment and the long term unemployment and improving the quality and efficiency of the public administration and the judicial system. Also, Romania should make significant efforts to increase the very low absorption rate of the European funds.

Romanian legislation does not fulfil all the requirements for the central bank independence, the monetary financing prohibition and the legal integration of the central bank into the Euro system. Romania is an EU member state that is the subject to derogation and, therefore, it must conform to all adaptation requirements laid down in Article 131 of the Treaty.

5. Convergence Programme for the period 2016-2019 on the monetary policy and the exchange rate

The 2016 edition of the Convergence Programme for the period 2016- 2019 has been developed on the basis of Regulation (EC) No. 1466/1997 of the Council regarding the surveillance consolidation of the budgetary positions and the surveillance and coordination of the economic policies, as amended by Regulation (EC) no. 1055/2005 of the Council and Regulation (EU) no. 1175/2011 of the European Parliament and the Council.

Convergence Programme was achieved taking into account the Code of Conduct on the specifications of the Stability and Growth Pact implementation and the guidelines for the format and content of Stability and Convergence Programmes of 3 September 2012.

The 2016 edition of the Convergence Programme was based on provisions of the Strategy budgetary and fiscal and the updated macroeconomic framework for the period 2016-2018. The national budgetary planning has estimated a budget deficit ESA of 2.9% of GDP for the years 2016 and 2017.

Commitment to adopt the euro is still an important anchor in promoting the budgetary and structural reforms to increase the flexibility of the Romanian economy. In terms of the real convergence, assessed by the gaps with the European average of the gross domestic product (GDP) per inhabitant expressed in purchasing power standard (PPS), Romania has progressed significantly in the last two years, standing at around 55% to the EU average - 28, compared to 52% in 2010. According to the economic evolutions explained in this program, the real convergence of Romania will reach in 2018 to about 65%, with the prospect that by 2020 GDP per inhabitant in PPS from Romania to represent 70% of the European average.

Table 2. Average annual rate of the GDP growth in the period 2010 - 2015 (%)

	UE28	**ROMANIA**
Real growth	1.1	1.8
Deflator	1.8	3.7
Nominal growth	3.0	5.7
The GDP growth per inhabitant at the purchasing power standard	2.4	5.0

Source: Convergence Report, 2016-2019, http://discutii.mfinante.ro

In accordance with the Government Programme, the medium-term economic strategy of the Government is oriented towards the promoting of the competitiveness and employment, continuing the implementation of the structural reforms, improvement of attracting the European funds, consolidation of the financial stability and of the public finances from 2018.

Romania has made considerable progress in recent years in reducing the macroeconomic imbalances, which together with the monetary policies and the structural reforms implemented or under implementation, have helped to maintain the macroeconomic and the financial stability. After the economic crisis, Romania had a modest economic recovery, with annual increases below 1%, after that, the advance of the real GDP rebounded in 2013-2015 at an annual rate of 3.4%. Unemployment has continued to remain at a low level in the last years, it was below 7%, while investments have increased again, reaching an annual growth rate of 17.6% in the last quarter of last year. However Romania has one of the highest rates of the poverty or the social exclusion in the EU (40.2% versus 24.4% for the whole EU-28 in 2014).

Although this trend is declining, the poverty rate among the persons employed in the labour market also remains the highest in the EU. In addition, there are still significant wide gaps between the rural and the urban areas, Romania facing the high poverty risks, the social exclusion and income inequalities. In the rural area, the poverty and the social exclusion rate is double that recorded in the urban areas, respectively 55% compared to 27.9%.

Since the second half of 2014, Romania has implemented a series of the fiscal policy measures to reduce the taxes in order to stimulate the economic growth. A first measure of loosening the fiscal policy was to reduce the labour taxes by reducing with 5 percentage points the social security contributions, implemented since October 2014.

Regarding the VAT, there were gradually introduced the reduced rate for several product categories as follows: bread and bakery products (9% since September 2013), foodstuffs (9% since June 2015) and books and cultural services (5% since January 2016). Also, since January 2016, the standard rate has been reduced from 24% to 20%, according to the new Fiscal Code. Reductions of the VAT rates have stimulated the consumption and investment with impact in the short term, on the economic growth.

Another measure with positive impact on the household disposable income provided by the Fiscal Code is increasing the personal deductions granted from the income tax based on the number of dependents. In addition to these measures, the revised Fiscal Code provides a substantial change in terms of dividend tax that has been reduced from 16% to 5% since January 2016. Also, since this year, the enterprises that have more than 2 employees will benefit from a significant reduction.

According to its statute, the National Bank of Romania has the fundamental objective of ensuring and maintaining the price stability, representing the best contribution that monetary policy can make to achieve the sustainable economic growth. Setting up and implementing the monetary policy of the National Bank of Romania is done within the context of inflation targeting, which coexist with the managed floating regime of the exchange rate of the leu; it allows a flexible response to shocks that may hit the economy being at the same time, compatible with the use of the inflation target as the nominal anchor for monetary policy.

According to its current institutional characteristics, the monetary policy of NBR consequently aims to achieve the target inflation standing at 2.5 percent ± 1 percentage point - compatible with the price stability definition over the medium term in the Romanian economy - and lowering the annual inflation rate on the horizon farthest in time at the levels in line with the quantitative definition of the price stability adopted by the European Central Bank.

In the next period, the main challenge for the monetary policy will be the solid anchoring of the inflation expectations to ensure and maintain the price stability in the medium term in a manner that contributes to sustainable economic growth, in terms of relative compatibility with the cycles of the monetary policies of the central banks from the region and the euro area.

Both in the short-term and in the longer time horizon, the calibration of the parameters of the monetary policy instruments, including the interest rate level key of the NBR, in the context of adequacy the monetary policy will be mainly correlated with nature/ intensity of pressures on the future inflation arising from the cyclical position of the economy.

6. Conclusions

Romania's accession to the European Union means adopting the single currency in a frame time that depends on the degree of economic integration with the euro area. Between the five nominal convergence criteria, currently, in Romania fulfils those related to the budget deficit, the public debt as a percentage of GDP and inflation. Looking ahead, it is extremely important for our country to achieve and maintain healthy and sustainable fiscal positions. A strong nationally fiscal framework should support the fiscal consolidation and limit the slippages of the level of the public spending, while helping to avoid the recurrence of the macroeconomic imbalances. Consolidation strategies should focus on improving the quality of the public finances by strengthening the investments that will stimulate the productivity.

In addition, the exchange rate criterion cannot be considered as long as our country has not joined the ERM II. The criteria for entry into ERM II refers to an agreement that defines the specific conditions for participation in the exchange rate mechanism (ERM II), which will be signed by the President of the ECB and by the NBR governor. Previously, however, the finance ministers of the Member States from the euro area and the countries that participating in ERM II decides the rate of the leu (RON) against the euro and the standard fluctuation band for mandatory intervention of the central banks participating.

Achieving the interest rate criterion in the long term is conditioned largely by achieving the inflation rate criterion. Average annual rate of the HICP inflation recorded in Romania was -1.3%, a level below the reference value of 0.7% for the criterion on the price stability.

Creating, maintaining and further strengthening of the favourable environment to the price stability will depend essentially by achieving further efforts in terms of the fiscal policy, especially through the implementation of credible consolidation measures.

The wage increases should not exceed the productivity growth and should take account of conditions in the labour market. In terms of the real convergence, assessed by the gaps with the European average of the gross domestic product (GDP) per inhabitant, expressed in purchasing power standard (PPS), Romania has progressed significantly in the last two years, standing at around 55% to the EU average - 28, compared to 52% in 2010.

The legal framework is not fully compatible with all requirements for euro adoption in any of the five analysed countries. There are incompatibilities as regards the central bank independence, particularly institutional and financial independence of the central banks, as well as the personal independence. In addition, in all analysed countries, there are incompatibilities on the monetary financing prohibition and the legal integration of respective central banks, into the Euro system.

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