ROMANIA’S PROGRESS IN THE CONVERGENCE PROCESS

Adrian-Milutin TRUICHICI, PhD*
Associate Professor, Faculty of Law, "Titu Maiorescu" University, Bucharest
Associate Researcher, "Acad. Andrei Rădulescu"
Institute of the Romanian Academy
Lawyer, Bucharest Bar, ROMANIA

Luiza NEAGU, PhD**
Lawyer, Bucharest Bar, ROMANIA

Abstract:
The paper presents the progress made by Romania in the process of convergence\(^1\) in view of the Treaty on the Functioning of the European Union.

Keywords: Single European currency, convergence criteria, average annual inflation rate, gross domestic product, long-term interest rate.

1. Introductory remarks
Since the introduction of the euro in 11 European Union Member States on January 1, 1999, another seven countries joined the Eurozone, the most recent case being Latvia on January 1, 2014. Following Croatia’s accession to the European Union on July 1, 2013, there are 10 Member States that are not full participants in EMU\(^2\), meaning they have not adopted the euro yet\(^3\).

Under the Treaty on the Functioning of the European Union, the following countries pledged to adopt the euro: Bulgaria, the Czech Republic, Croatia, Lithuania, Hungary, Poland, Romania, and Sweden. This involves, from the part of these countries, efforts aimed at fulfilling all the convergence criteria\(^4\).

* E-mail: adrian_truichici@yahoo.com.
** E-mail: cabinetavocatura@yahoo.com.

\(^1\) Before it could adopt the euro as its single currency, a Member State must meet a number of economic and financial conditions, also called "convergence criteria". There are four conditions: price stability; state of public finances; participation in the exchange rate mechanism of the European Monetary System; convergence of interest rates.

\(^2\) Economic and Monetary Union.

\(^3\) Two of these states, Denmark and the United Kingdom, notified that they would not participate in Stage Three of EMU.

\(^4\) N. Pop, Adoptarea euro de către România: recomandări pentru pregătirea unei strategii de succes, Centrul de Informare și Documentare Economică, Bucharest, 2005, p. 4.
The euro changeover is contingent on the fulfilment in a sustainable manner of the nominal convergence criteria and of the legal convergence ones. When examining the sustainability of the convergence process, there are taken into account a number of economic indicators that define the so-called real convergence, such as: GDP per capita, openness of economy, structure of economy, financing of current account deficit, labour costs, degree of financial intermediation etc.

2. The process of economic convergence

The process of economic convergence facilitates the objective of the monetary policy, which is maintaining a stable level of prices throughout the Eurozone, thereby contributing to the achievement of a non-inflationary growth. Looking in perspective, the European Union Member States that are to adopt the euro in the future will have to ensure the convergence of their own economies with the economy of the Eurozone.

In 1993, the Maastricht Treaty established five criteria that the Member States must meet in order to join the EMU and consequently adopt the euro:

a) An inflation rate of no more than 1.5% above the average of the first three Member States with the best performance in price stability;

b) The long-term nominal interest rate should not exceed by more than 2% the average interest rate in the first three Member States with the best performance in price stability;

c) The budget deficit should not exceed 3% of GDP;

d) The debt-to-GDP ratio should not exceed 60%;

e) The fluctuation margins should tally the margins established by the European Monetary System: within ±15% in the two years preceding the examination (in actual fact, in the technical negotiations the fluctuation margin accepted by the European Commission is 15% / -2.25%).

3. Real convergence

Real convergence means that the disparity between standards of living as to income and productivity across a certain zone tends to disappear or the structural disparities influencing a country’s competitiveness are diminished.

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5 Gross Domestic Product.
7 Criteriile de convergență, article published at http://www.ecb.int/ecb/educational/facts/euint/html
8 We must recall that Denmark and the United Kingdom are subject to a derogation from the third stage of the Economic and Monetary Union. These two Member States do not envisage adopting the euro yet. Therefore, they are exempt from obligations relating to the convergence criteria.
According to the Maastricht Treaty, real convergence designates "the long-term process of reducing the disparities between the standards of living, which represents a fundamental objective of the Community", referring to levels of economic and social development.\(^{11}\)

In the long term, the levels of GDPs per capita in the EU Member States grew noticeably closer, with less developed countries registering a faster growth than the rich ones. Nevertheless, the specific contribution of the European integration process to this convergence is far from being evident, as in most cases the approach in the standards of living was actually more pronounced before the accession than after it.

Similarly, recent developments seem to indicate that a forced nominal convergence is accompanied by a general slowdown in growth, which does not foster recovery by the less developed countries, even if a substantial increase in transfers of structural funds could have beneficial effects.\(^{12}\)

### 4. Nominal convergence

Nominal convergence regards the evolution of cost and price variables and of their deep determinants (interest rate, exchange rate, budget deficit, public debt).\(^{13}\)

The criteria included in the Maastricht Treaty pertain to the nominal convergence of the European Union countries, which is to be evaluated for each country by the European Council before proceeding to Stage Three of EMU.

In order to ensure sustainable convergence, the Treaty on the Functioning of the European Union (Lisbon Treaty - TFEU) establishes the criteria that have to be met by each Member State of the European Union before they could participate in the third stage of the Economic and Monetary Union:

- A Member State should not be the object of a Council decision concerning excessive budget deficit;
- There must be a sustainable price stability and an average inflation rate which, in the year prior to the examination, should not exceed by more than 1.5% the inflation rate of at most three Member States having the best results in price stability;\(^{14}\)
- The long-term nominal interest should not exceed by more than 2% that of at most three Member States with the best results in price stability;
- The normal fluctuation margins stipulated by the exchange rate mechanism must be observed without severe tensions in the latter for at least the last two years before the examination;

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\(^{12}\) *Criteriile de convergență*, article published at http://www.ecb.int/eca/educational/facts/euint/html


• Member States should ensure that their national legislation, including the statutes of their national central banks (NCBs), is compatible with both Articles 130 and 131 of the Treaty and with the Statute of the European System of Central Banks. This obligation, applicable to Member States with a derogation, is also referred to as "legal convergence".\(^{15}\)

The convergence criteria are meant to ensure balanced economic developments within EMU, which should not cause tensions between the Member States of the European Union.\(^{16}\) It must also be recalled that it is mandatory to continue complying with the criteria regarding the public deficit and the public debt after the start of the third stage of EMU (January 1, 1999) as well. In this respect, the Stability and Growth Pact was adopted at the European Council meeting held in Amsterdam in June 1997.\(^{17}\)

5. The Convergence Reports of the European Central Bank

By the Convergence Reports, the ECB\(^{18}\), at least once every two years or at the request of a Member State of the European Union,\(^{19}\) analyzes the progress made by the Member States in fulfilling their obligations in achieving the economic and monetary union or in joining the single European currency.

It is to be mentioned that the evaluation of the process of economic convergence depends to a large extent on the quality and integrity of the statistics provided by the countries under analysis. For this reason, the compilation and reporting of statistics, particularly of those pertaining to government finance, should not be influenced by political considerations or interference.\(^{20}\)

As far as Romania is concerned,\(^{21}\) within the reference period May 2013 - April 2014, the average annual rate of HICP\(^{22}\) inflation in Romania was 2.1%, \(i.e.\) above the reference value of 1.7% for the criterion on price stability.

\(^{15}\) Criteriile de convergență, article published at http://www.ecb.int/ecb/educational/facts/euint/html


\(^{17}\) Criteriile de convergență, article published at http://www.ecb.int/ecb/educational/facts/euint/html

\(^{18}\) European Central Bank.

\(^{19}\) Article 140 of the Treaty on the Functioning of the European Union as regards reporting to the Council of the European Union.

\(^{20}\) It was recommended to the Member States to consider the quality and integrity of their statistics as a priority, to ensure an adequate system of verification and corroboration when compiling these statistics, and to apply certain standards in the field of statistics. These standards are of particular importance, strengthening the independence, integrity and accountability of the national statistics institutes and contributing to increased confidence in the quality of public finance statistics.

\(^{21}\) Romania is a Member State of the European Union with a derogation and must therefore comply with all the adaptation requirements under Article 131 of the Treaty on the Functioning of the European Union.

\(^{22}\) Harmonised Index of Consumer Prices. 
Looking back over a longer period, the average annual rate of HICP inflation in Romania decreased from very high levels in the early 2000s up to 2007, when the downward trend was reversed. In 2009 inflation fell again and broadly stabilised thereafter at an elevated level, before declining to historically low levels of 3.4% and 3.2% in 2012 and 2013 respectively. In addition to unit labour costs, a succession of major supply-side shocks (including a VAT rate hike in 2010), adjustments in administered prices and excise duties, and the exchange rate developments played a major role in inflation developments. Inflation dynamics over the past ten years should be viewed against a background of “overheating” in the economy from 2004 to 2008, which was followed by a sharp contraction of economic activity in 2009 and 2010, and by a moderate recovery from 2011 to 2013.

During the period 2004-2008, unemployment declined and wage growth significantly outpaced productivity growth, which in turn drove up unit labour cost growth to double-digit levels. As unemployment picked up again and wage growth moderated significantly, unit labour cost growth fell from 22.9% in 2008 to 2.5% in 2013. Looking at recent developments, annual HICP inflation broadly followed a downward path from its peak of 5.4% in September 2012 to 1.1% in September 2013, before picking up to a certain extent to 1.6% in April 2014, following an increase in excise duties on fuel. This marked overall decline can be attributed to a reduction in the VAT rate on flour and bakery products in September 2013, as well as to easing pressures from energy and food prices against the background of global price developments, a very good harvest, downward base effects, the disinflationary pressures exerted by the negative output gap and falling inflation expectations.

The latest available forecasts from major international institutions envisage average annual inflation rising gradually from historically low levels and ranging from 2.2% to 2.5% in 2014 and from 3.0% to 3.3% in 2015. While immediate risks regarding the inflation outlook are broadly balanced, upside risks prevail in the medium term. They relate to a stronger than expected rise in global prices of raw materials and to depreciation pressures on the Romanian currency resulting from renewed tensions in global financial markets. Risks from domestic sources are associated with the impact of further deregulation of energy prices and with hikes in excise duties as well as persistent uncertainty regarding the progress made in implementing the structural reform measures agreed upon in the precautionary financial assistance programme.

Lower than expected economic activity constitutes a downside risk to the inflation outlook. Looking further ahead, the catching-up process is likely to have a

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23 The dynamics of inflation in the last ten years should be considered in the context of “overheating of economy” in 2004-2008, followed by a sharp contraction of economic activity in 2009 and 2010 and a moderate recovery in 2011-2013. In the period 2004-2008, unemployment declined and earnings growth rate significantly exceeded productivity, which resulted in an acceleration of the growth of unit labour costs of up to double-digit levels.
bearing on inflation and/or the nominal exchange rate in the years to come, given that the levels of the GDP per capita and of prices are still significantly lower in Romania than in the eurozone. However, it is difficult to assess the exact magnitude of the effect that this catching-up process might have on inflation.

Romania is not currently subject to a European Union Council decision on the existence of an excessive deficit. In the reference year 2013 the general government budget balance recorded a deficit of 2.3% of GDP, i.e. below the 3% reference value, and the debt-GDP ratio was 38.4%, a level significantly lower than the reference value of 60%.

It is important for Romania to ensure that sufficient progress should be made towards the accomplishment of the medium-term budgetary objective, namely a structural deficit of 1% of GDP, and the fulfilment of commitments under the agreement of financial assistance concluded with the European Union and the International Monetary Fund. In addition, Romania has to cope with fiscal challenges, within the two-year reference period, as the Romanian Leu is not part of ERM II, but is traded under a flexible managed float regime of the exchange rate.

The exchange rate of the Romanian Leu against the euro showed a relatively high degree of volatility. Following a slight appreciation of the Romanian Leu up to May 2013, the currency weakened during a period of increased volatility in mid-2013. Thereafter the leu strengthened again to a certain extent, stabilising around the average level it had at the beginning of the reference period. Over the entire reference period, short-term interest rate differentials against the three-month EURIBOR remained, on average, at a high level, although they declined gradually amid interest rate cuts operated by the National Bank of Romania against the background of decreasing inflation differentials compared to the Eurozone.

During the reference period Romania did not draw on the resources available under the precautionary arrangements. As these agreements helped to reduce financial vulnerabilities, they might also have contributed to the reduction of the exchange rate pressures over the reference period. In a longer-term context, in April 2014 both the real effective exchange rate and the real bilateral exchange rate

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25 Exchange Rate Mechanism II.


27 EURIBOR (Euro Interbank Offered Rate) is the reference rate for the euro monetary market, founded in 1999.

28 In 2009 it was agreed to grant a package of international financial assistance to Romania by the European Union and International Monetary Fund, followed by a precautionary financial assistance agreement in 2011 and by an additional similar programme in 2013.
of the Romanian Leu against the euro stood relatively close to the corresponding ten-year historical averages. As regards other external developments, Romania’s cumulative current and capital account balance has adjusted substantially in recent years. After reporting a progressive increase in the external deficit between 2004 and 2007, the combined current and capital account deficit adjusted in 2009, improving further to 3.0% of GDP in 2012 and turning into a surplus of 1.2% of GDP in 2013. At the same time, the country’s net international investment position deteriorated substantially from -26.4% of GDP in 2004 to -67.5% in 2012, but improved to -62.3% in 2013. Fiscal and structural policies continue therefore to be important in supporting external sustainability and the competitiveness of the economy.

Long-term interest rates were 5.3% on average over the reference period May 2013 – April 2014 and were thus below the 6.2% reference value for the interest rate convergence criterion. In the previous years, long-term interest rates in Romania tended to fluctuate around 7%, within a margin of ±0.5%, with persistent inflation preventing a sustained downward trend in nominal interest rates. More recently, inflation declined sharply, allowing the central bank to ease monetary policy rates faster than before. This contributed to the narrowing of the long-term interest rate differential between Romania and the Eurozone average.

At the end of the reference period, the long-term interest rate stood at 5.2%, with 2.8% above the Eurozone average and with 3.5% above the yield of the AAA-rated sovereign bonds from the Eurozone).

6. Conclusions

Achieving an environment conducive to sustainable convergence in Romania requires, among other things, the pursuit of economic policies meant to ensure overall macroeconomic stability, including sustainable price stability.

Regarding its macroeconomic imbalances, the country is subject to surveillance under a macroeconomic adjustment programme supported by financial assistance. Romania is confronted with a wide range of challenges in the field of economic policies.

Romanian legislation does not meet all the requirements for central bank independence, the ban on monetary financing and the legal integration of the central bank into the Eurosystem. Romania is a Member State of the European

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29 Following the progressive increase of the external deficit in 2004-2007, the cumulative current account and capital deficit underwent an adjustment in 2009 and continued to improve, reaching 3.0% of GDP in 2012, and in 2013 it registered a surplus of 1.2% of GDP.

30 The highest possible rating assigned to the bonds of an issuer by credit rating agencies. AAA-rated issuers have an exceptional degree of creditworthiness and can easily meet their financial commitments. Agencies such as Standard & Poor’s and Fitch Ratings use the AAA nomenclature to indicate the highest credit quality, while Moody’s uses Aaa.

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