European Institute of Romania

Romania and the accession to the Eurozone: the question is IN WHICH CONDITIONS!

Executive Summary

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- HIGHLIGHTS –

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Accession to Eurozone (EZ), which is foreseen by the Treaty of Accession to the European Union and in the Treaty of Functioning of European Union should be a decision made rationally, considering lessons of the last decades and major problems which are facing the European Union (EU).

EZ membership has benefits, such as: stimulation of trade among member states, reduction of transaction costs, removal of currency risk, the advantage of a shelter common currency against destabilizing capital flows; accession could strengthen the insertion in the basic European industrial networks which was boosted by the EU accession. The accession would mean belonging to the first concentric circle of the Union. It would, consequently, have a geopolitical dimension against the backdrop of the uncertainties entailed by the myriad of crises of recent years, including Brexit and strong centrifugal tendencies in EU.

On the other hand, the arguments for a fast accession should be thoroughly examined. This examination needs to take into account the lessons of the EZ crisis.

Lessons of the Eurozone crisis

The special operations of the European Central Bank (ECB) prevented the collapse of EZ. But these operations cannot hide the faults of an incomplete construction, which have come amply into the open after the financial crisis irrupted.

Big lessons of the EZ crisis are:

- EZ did not allow a sufficient convergence between member states, and preserved big disequilibria (competitiveness gaps) between North and South.
- The thesis that EZ is not an optimum monetary area (among structurally compatible economies) has been proven to be correct; it does emphasize the importance of real and structural convergence.
- EZ has no tools yet for dealing with asymmetric shocks, as it should be the case in a genuine monetary union (as in USA, or Germany as a federal state).
- The *policy space* matters a lot when strong adverse shocks occur; currently, EZ allows only internal devaluations as a correction process, which is pretty costly socially and politically.

For a better understanding of the economics of accession to and the workings of EZ it is worthwhile to read carefully the Report of the Five Presidents (2015). Besides the problem of real convergence, for the first time an official document of EU clearly and directly speaks out about major flaws of the monetary union construction, and admits , among others, the need for common mechanisms of stabilization and a common treasury.

In the internal public debate (in Romania) there is a strand of thought which favours a rapid accession to EZ. There are economic arguments regarding rapid accession. One would be that the fast accession is the only way to offer a new strategic aim for the development of the country, without which the internal resources cannot be capitalized upon. But, why would EZ accession be more appealing for citizens than a development program involving concrete highways, roads, the development of overall infrastructure, more resources for education and health? This implies a development strategy, a country project.

Another argument is the degree of euroization – currently in Romania 45% of the transactions are denominated in euro. The accession into EZ would eliminate the currency risk which affects many citizens. But, a legitimate question arises, should euroization, be it still significant, be the determining factor for EZ accession? Domestic currency-denominated transactions have increased constantly in recent years, as inflation and interest rates have declined; this is a welcome development, which weakens the power of the euroization argument. It is true that big speculative capital movements may destabilize a small economy and can erode the efficacy of autonomous monetary policy. But, we do not think that this feature of the global economy cancel the advantage of having an own monetary policy and exchange rate policy –especially when EZ has no adequate arrangements and mechanisms to deal with asymmetric shocks.

Finally, there is a political and geopolitical argument, the symbolic value attached to accession in the hard core of EU, the EZ. While this argument should not be underestimated, it should be balanced with the circumstances of an economy that is not structurally compatible yet with the rigors of a monetary area, (which, moreover, is incomplete in terms of mechanisms and tools).

Is there a need for a critical mass of convergence *ex ante*?

Nominal criteria are not sufficient for accession to EZ. Empirical evidence shows that without appropriate structural compatibility, which would correspond to durable real convergence (income per capita), the position in EZ is precarious and entails great risks. Here we refer not to simple working hypothesis, but to concrete facts, experiences of some economies that were not well prepared at the moment of accession to EZ (Spain, Portugal, Greece, etc.). It is not by chance that professional debates point out the OCA (optimal currency area) convergence as a critical factor. Romania currently has a GDP/capita 28% at current prices in euro and 57% in PPS of the ZE average; these are small figures and in addition our economy has to overcome large structural gaps; Romania has considerable internal regional disparities too. And the accession to ZE is made by the whole country, and not by pieces.

EZ has a big problem of heterogeneity and big economic performance discrepancies between member states, which generated significant external deficits – be they mirrored by the same currency inside ZE. This is the explanation why major external disequilibria led to sovereign debt crises after governments took over private debts and turned them into public debts.

In EZ, how currently it does work, the set of choices for the management of disequilibria is limited: the control of budget and quasi –fiscal deficits (if there are any) in the public domain and wage and other income cuts, when is the latter are required. As the EZ crisis and other episodes of crisis (in Asia, Latin America in previous decades) show, large external disequilibria can originate in the over indebtedness of the private sector. Why has over-indebtedness in the private sector came up? Because, as economic textbooks show, capital moves from where it is saved to where it is demanded and where, presumably, yields are superior. Capital moved more into non-tradable sectors, conjecturally profitable, due to lax credit conditions, incompleteness of the common market and imperfect competition, which allowed excessive rent extraction. This happened in Central and Eastern Europe, included Romania too. The economic logic of capital flows is difficult to reject. One sees here how fragile is the argument that big development gaps do not matter, that once being inside the EZ, things adjust automatically –according to the free movement of production factors.

One could argue that, in views lessons of the current crisis, the solution is the application of macro prudential measures to restrict lending to private sector. But, it is not clear at all whether such measures would be efficient because these are largely untested. One can suppose as well that the new governance in EZ and EU in general might limit disequilibria decisively. But these rules are not tested appropriately either. In addition, there is hardly a policy stance in ZE to limit its deflationary bias – the result is a surplus of the current account in ZE of approx. 3% of GDP and of approx. 9% of GDP in Germany currently.

The convergence gap regards not only the above mentioned facets. In countries with the income per capita considerably inferior to the ZE average, the inflation differential is likely to be significantly positive. This means that, in time, if there is no competitiveness gain, external disequilibria would grow. Once in EZ, the degree of freedom in terms of disequilibria correction is lower. The larger the structural differences between economies, the more uncertain the capacity for adjustment is.

Does it matter how Eurozone works?

If we think about means to deal with asymmetric shocks (besides automatic stabilizers at national level) we end up with the ZE functioning; this is the second key problem for a serious discussion about accession. Despite all the progress done in reforming its institutions and policies, EZ has major deficiencies yet. This situation is acknowledged by top officials from European institutions and national governments.

EZ is currently, we dare to say, more a sort of a "single currency area" (similar to the gold standard from inter-war period). It is true that currency risk was removed, which is an undisputed advantage. And it is also true that EZ can help protecting an economy against destabilizing capital moves. But this argument is, in our opinion, not decisive to legitimate the way the ZE dies function currently. We too consider that The European Mechanism for Stability, the Banking Union, and other tools created in the wake of the EZ crisis have not succeeded to solve essential problems, that additional reforms are required.

Policy space matters greatly for an economy with important rigidities and in need of major structural reforms. The following argument could calm down concerns regarding the functioning of EZ: deeper fiscal and political integration which would allow the transfer of resources and would make irrelevant disequilibria between EZ member states (let us remember the resources transferred to the eastern lands from western lands after Germany's reunification). But, such a hypothesis is a fantasy in current conditions.

Therefore, we have to find an optimum way between the achievement of a critical mass of structural and real convergence *ex ante* relying betting, at the same time, on further reforms of EZ. Year 2019 is too near from this point of view. It is not, we consider a credible target for our main European counterparties either. One must say that Romania would join EZ if it is accepted too, and not because there is a will in Bucharest to achieve this aim.

Not to mention another great problem of the EZ, namely the lack of symmetry in adjustments. Economic theory says that, in international economic relations, good for lenders and borrowers are when adjustments are done on both sides, when deficits and surpluses are reduced even if not at the same time; it is good that there should be burden-sharing over time in this regard. In the EZ, that would mean that countries with fiscal space should stimulate their economies to boost aggregate demand when other troubled countries undertake large macro corrections. But who can impose symmetric corrections. So far, the Commission proved to be powerless.

It is possible to join the Banking Union before joining EZ, by taking into account the integration of EU financial markets, the large presence of European banking groups in Romania, and the tight cooperation of specialized domestic institutions (NBR, ASF) with European institutions within European Central Banks System and the new regulatory and super*vi*sory architecture for financial markets (EBA, ESMA, EIOPA, ESRB).

Deep structural reforms, growth based on productivity gains -which means more public and private investments, technological innovation - are needed. Essential public goods are needed (basic infrastructure, education, health), which should be financed by an adequate amount of fiscal revenues (not with 27-28% of GDP as it is currently, while the EZ average is of approx. 40%). A growth model able to build competitive advantages and avoid the middle income trap is needed.

Conclusion of our analysis

1. There are two fundamental pre-conditions for accession to EZ: a) the achievement of a critical mass of real convergence ex ante (before accession) and the fulfilment of a range of structural conditions, b) the reform of the mechanisms and policy arrangements in EZ.

2. The accession will be a political decision, which has to rely on a large democratic support.

3. Our analysis does not ignore the strategic (geo-political) imperatives which might hasten Accession.

4. The large development gap between Romania and EZ is, arguably, the key impediment in adopting the common currency.

5. Besides the problem of economic gaps, there is a flawed working of EZ. These two fundamental problems point out the scale of risks attached to a premature accession to EZ.

6. The essential factor for real convergence is competitiveness. Our analysis shows common problems regarding competitiveness in the region considered. The distance to the benchmarks provided by German standards (as, probably, the most performing economy in EU) is large in tamers of infrastructure, institutional development, business sophistication, and above all, innovation. The largest distance is registered by Romania, while the Czech Republic is nearest to the German economy from this perspective.

7. If Romania would keep the average growth rate of 2000-2015, then it would catch up the EZ average in 27 years, and 75% of the EZ average in 13 years (2.5pp growth differential compared to EZ average yearly growth rate of 2000-2015 - 1.18%). If Romania would grow by an average of 5% each year (in a sustainable manner) then it would catch up the EZ average in 18 years, and the 75% of EZ average in 9 years, that is in 2024 (3.8pp growth differential compared to the EZ average yearly growth rate of 2000-2015 -1.18%)[1].

8. EZ accession does not require the achievement of the EZ average level of GDP/capita. As we argue, one can imagine the accession after achieving 75% of the EZ average and the fulfilment of other structural conditions.

9. We think that Romania should target a GDP/capita in PPS of at least 75% of the EZ average at the date of accession. The Baltic States are not relevant cases taking into account their dimension and the currency board arrangements which predisposed to a policy option.

10. The structural convergence analysis has to be nuanced. For example, over--financialization of the economy brings costs. And a strong industry, which seems disproportionate as a weight in the GDP formation (as it is the case of Germany) is not automatically bad. It remains to be seen about what kind of services we are talking about, what the structure of the industry is and which the domains are with high value added.

[1] If we assume that the GDP per capita in PPS in EZ would grow with the average rate of 2007-2015 and Romania's GDP/capita in PPS would keep growing with a rate higher by 3pp than a 100% convergence would be achieved in 2035 and 75% convergence in 2025. Whereas, if in Romania GDP/capita in PPS would grow with a rate higher by 4pp than the GDP/capita in EZ after 2015 then the 100% convergence will be achieved in 2031 and 75% convergence in 2023.

11. The moment of accession to EZ should not depend on its total compatibility with EZ, but rather by the achievement of a critical mass of structural convergence, which should make it safe to function in a monetary union.

12. The labour force mobility between regions y is low and enhances income gaps among regions. Conversely, the international migration is very high. We face the challenge to overcome the middle income trap, which implies another development model; in addition the removal of factors which maintain low labour productivity is of crucial importance for development. It is important to increase the propensity of international companies to promote businesses with high value added in Romania (when the decisions are taken at headquarters). It is a question whether public policies (industrial) can help in this respect.

13. It is welcome the rising degree of de-euroization of the domestic economy in the last years; this is helping the transmission mechanism of monetary policy and the robustness of the economy. De-euroization increases the efficacy of monetary policy and eases the managed floating regime – the income and wealth effect of a depreciation of the domestic currency is attenuated by the decline in euroization - even if the legacy effect (related to the stock of euro loans) is still significant.

14. If Romania joins EZ with large development gap there is a risk of higher inflation than in EZ, which could lead to lower real interest rates than in the rest of EZ and depreciation of the exchange rate in real terms, as it was the case in Spain and Portugal. It is not clear whether macro-prudential measures would be sufficient to counteract unfavourable capital moves.

15. The appreciation tendency of the exchange rate could counter balance the pro-cyclical behaviour generated by the persistence of lower real interest rates. But, the counterbalancing effects through the appreciation of RON are not desirable.

16. In time, resource allocation can be distorted towards non-tradable- this is what happened in Romania after 2004-2005. The success stories in the global economy are related to exchange rate policies which did not tolerate un-sustainable appreciations; they relied on appropriate productivity gains competitive advantage build-up.

17. The true stake of euro adoption in Romania should be *neither if nor when*, but in what circumstances, how it will be done. In essence, for the adoption of euro in Romania to be a success for its citizens, we consider that a critical mass of real and structural convergence *ex ante* is needed.

18. It is to repeat: if Romania would grow on average in real terms by 5% per year in a sustainable manner, then it could catch up the average EZ level in 18 years and 75% of the EZ average in 9 years that is in 2024[2].

19. Romania can join the Banking Union before accession to EZ.

20. Romania should rely more on endogenous engines of growth. Taking into account the international context, another growth model, based more on internal saving and investment, internal resources mobilization and qualitative aspects, is needed. This aim should be followed alongside with the attraction of high quality foreign inward investment and more intense absorption of European funds.

21. Romania should be involved in the rethinking of the functioning model of the single market, which should work for EU citizens. Without inclusive economic processes, defined by, among others, fairness, transparency, social cohesion will suffer more and more extremist political factions will gain the upper-handed.

[2] In all cases EZ would grow by the average historical rate of the analysed period (2000-2015) by 1.18% per year.

22. In the Union, there should be a vigorous fight again fiscal evasion and tax avoidance, which weakens the trust of citizens in the democratic state; these nuisances are massively present in the way Romanian economy functions.

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The research is structured in four parts. *The first part* summarizes the theoretical background of monetary unions. From the classical theory of optimum currency areas till the more recent theories – the endogeneity theory, the specialization theory, impossible dilemma versus impossible trilemma etc. Empirical evidence on the functioning of ZE is presented and several findings made.

The second part deepens those findings, lessons related to EZ, which went through several phases during its lifetime: the enthusiasm of beginnings, the doubts empirically validated reform attempts. The reforms initiated in the institutional architecture of EMU, in basic mechanisms and in EZ governance are analysed; the syndrome of very low interest rates in industrialized world, which affects economic policies and the state of economies, is examined.

The third part studies risks and benefits of accession to EZ for Romania; there is a comparative analysis of Romania's economic situation; the sequencing of the euro adoption is analysed from many perspectives. Starting from the lessons of EZ, and the experience of countries from Central and Eastern Europe already in EZ, an accession to EZ strategy outline for Romania is presented. Among the themes tackled are: the formal juridical frame (Maastricht Treaty, Fiscal Treaty, Macroeconomic Imbalanced Procedure Scoreboard); informal frame which proved to have a great importance in the cost-benefit balance of the accession to EZ - real convergence versus structural convergence, integration degree of Romania in EZ, the synchronization of the Romania's business cycle with that of EZ, the implications of euroization, alternative adjustments mechanisms of the Romanian economy necessary after the loss of national monetary policy.

The last part comes with conclusions and recommendations which can be related to the strategy *Competitive Romania*.

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